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H.R. 3396, THE RETIREMENT PROTECTION ACT OF 1993

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

TUESDAY, APRIL 19, 1994

Serial 103–74

Printed for the use of the Committee on Ways and Means

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H.R. 3396, THE RETIREMENT PROTECTION ACT OF 1993

TUESDAY, APRIL 19, 1994

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to call, at 10:03 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, MARCH 25, 1994

PRESS RELEASE #21
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON H.R. 3396, THE RETIREMENT PROTECTION ACT OF 1993

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a public hearing on H.R. 3396, the "Retirement Protection Act of 1993" (the Act). The hearing will be held on Tuesday, April 19, 1994, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing this hearing, Chairman Rostenkowski stated: "The Committee is holding a hearing at this time in response to the Administration's request for prompt consideration of its proposals to reform the federally insured defined-benefit pension system and to improve the security of certain pension benefits insured by the Pension Benefit Guaranty Corporation (PBGC). Furthermore, this hearing is being held pursuant to the recommendations of the Subcommittee on Oversight, as contained in its June 4, 1993, report to the Committee (WMCP: 103-15).

"The Committee has received numerous reports from government agencies and private organizations concluding that pension underfunding is a serious problem which will only worsen unless legislative reforms are enacted. The PBGC continues to report significant increases in the level of underfunding of federally insured pension plans. In its most recent analysis, released in January 1994, the PBGC reported that total underfunding had reached $53 billion, an increase of $15 billion from the $38 billion of underfunding reported last year. The PBGC reported that over $14 billion of this underfunding is in plans sponsored by companies that are currently in financial difficulty. This represents a significant risk to the PBGC. In light of these findings, it is appropriate that the Committee give expeditious consideration to the reforms proposed by the Administration in the Pension Protection Act of 1993 and the recommendations of the Subcommittee on Oversight."

The Committee will receive testimony from representatives of the Departments of the Treasury and Labor, the PBGC, the U.S. General Accounting Office, as well as public witnesses.

SUMMARY OF H.R. 3396:

H.R. 3396, the Retirement Protection Act of 1993, addresses the following four major areas of reforms to the federally insured defined-benefit pension system: strengthened plan funding rules for underfunded plans, enhanced enforcement authority for PBGC, increased premiums for severely underfunded plans, and improved participant services.

The bill would strengthen plan funding for underfunded plans by modifying certain existing deficit reduction contribution requirements and funding rules. Under the bill, certain underfunded plans would be required to use certain interest and mortality assumptions and obtain approval from the Internal Revenue Service for changes in other assumptions which affect the determination of contributions. Further, under the bill, plan sponsors would be required to currently fund negotiated benefit increases in the year in which they become effective. In addition, plans would be required to maintain currently liquid assets equal to at least three years of benefit payments. Finally, to facilitate the orderly funding of plans, the bill would repeal the quarterly funding requirement for fully funded plans; eliminate the current 10-percent excise tax on certain carry forward contributions that exceed 25 percent of payroll in any plan year; and, eliminate the 10-percent excise tax on nondeductible contributions for plans with fewer than 100 participants that fully fund all benefit liabilities upon plan termination.

(MORE)

To enhance enforcement of the applicable provisions of the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 by the PBGC, the bill would require plan sponsors with over $50 million in unfunded liabilities to provide the PBGC with better actuarial and financial information; grant the plans a claim for pension underfunding against liquidating sponsors or their controlled group; prohibit employers from increasing benefits in underfunded plans during bankruptcy proceedings; and give the PBGC concurrent authority with the Department of Labor when missed contributions exceed $1 million. Also, the bill would enable the PBGC to seek judicial relief for compliance remedies, short of plan termination.

Under the bill, the current $53-per-participant annual cap on the variable-rate premium would be phased out over three years, beginning with plan years starting on or after July 1, 1994. This provision is intended to create a nexus between the amount of underfunded risk and the premium charged.

To improve participant services for people covered by defined-benefit pension plans, the bill would require plan sponsors to provide participants with a simplified explanation of the plan's underfunded status and the limits of PBGC guarantees, and to transfer to the PBGC assets sufficient to cover employees "missing" at the time a fully funded plan is terminated.

In addition, certain other miscellaneous changes affecting employee-benefit plans generally would be made, including specifying the interest and mortality rate assumptions that may be used to calculate lump-sum distributions; providing rounding rules for certain cost-of-living increases that affect benefit plans; and eliminating "age-weighted" profit-sharing plans and cross-tested defined-contribution plans.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721], no later than the close of business, Monday, April 11, 1994. The telephone request should be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are asked to summarize their written statement. In order for each witness to be heard, the Committee will adhere to the five minute rule. The full written statement of each witness will be included in the printed record. All witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statement to the Committee, 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, April 29, 1994, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515. If those

(MORE)

filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Chairman ROSTENKOWSKI. The committee will come to order. Today the full committee will hold a hearing on H.R. 3396, the Retirement Protection Act of 1993.

As many of you know, on October 28, 1993 at the request of the administration, I introduced this bill jointly with Chairman Ford of the Committee on Education and Labor. H.R. 3396 reflects the administration's proposal to the Congress for reform of the significant and chronic underfunding of certain federally insured pension plans.

Concern regarding the direct impact these underfunded plans will have on the financial solvency of the Pension Benefit Guaranty Corporation and concern for the security of millions of workers have brought us to this point today.

Many of you are aware that the issues surrounding underfunded pension plans have been the focus of a series of hearings before the Subcommittee on Oversight over the past 2 years.

One common theme has emerged from these hearings: Underfunding in certain pension plans is a serious problem that will only worsen unless legislative reforms are enacted.

I share the concern of the administration and my colleagues on these issues, as well as the belief that failure to act will present us with greater problems in the future. Thus it is my hope that we can move this legislation forward in a timely fashion.

Today, we expect to receive testimony from the Department of Labor, the Department of the Treasury, and the PBGC. In addition, we expect to hear from the U.S. General Accounting Office and various representatives of industry.

We welcome your views and candid testimony as we begin a process of enhancing security for the pension benefits of millions of our workers, while at the same time analyzing the concerns of the affected industry.

The Chair will now yield to the chairman of the subcommittee, Mr. Pickle.

Mr. PICKLE. Mr. Chairman, I want to thank you for holding these hearings and for your support in helping us find a better answer to our PBGC problem. I particularly want to commend Secretary Reich and other representatives of the Clinton administration for their commitment and their dedication and their leadership in developing the Retirement Protection Act of 1993.

For the committee's reminder, for the past 2 years, the Subcommittee on Oversight has held five hearings on the problem confronting the PBGC and the defined benefit pension system. Throughout this period, on a bipartisan basis, the subcommittee has consistently supported measures to address these problems.

I think it is important, Mr. Chairman, that we all recognize the current system is seriously flawed. Under current law, companies can avoid current adequate funding of their plans. Further, under the current premium structure administered by the PBGC, the premiums paid by companies with seriously underfunded plans do not reflect the risk these plans pose to the agency.

As a result, a small but significant number of companies have utilized this system to their advantage while shortchanging their workers of secured retirement benefits and concurrently, exposing

the PBGC and ultimately the American taxpayers to possible additional liability.

So today the PBGC guarantees over $53 billion in unfunded pension promises made by single employer pension plans. Of this unfunded liability, the PBGC estimates that over $13 billion will very likely be the real liability for that agency.

The PBGC presently has a deficit of $2.8 billion in its single employer program as a result of claims it has already accepted. So in recent years, the unfunded liability and the PBGC's deficit have increased dramatically and this growth shows no sign of abating.

I also note that the PBGC does not face immediate collapse and we ought to be clear about that. However, the PBGC, the General Accounting Office and the Congressional Budget Office have all testified that unless reforms are enacted, this situation will continue to worsen and will, at some point, require a congressional bailout.

There is no excuse for allowing this small number of plans to continue to abuse our current system for their own advantage while workers, retirees, and other responsible plans are put at a risk.

Mr. Chairman, I ask to provide a written statement of my comments for the record. I yield back the balance of my time.

[The opening statement follows:]

OPENING REMARKS BY J. J. PICKLE (D.-TEX) AT A HEARING BY THE COMMITTEE ON WAYS AND MEANS ON H.R. 3396, THE RETIREMENT PROTECTION ACT OF 1993 TUESDAY, APRIL 19, 1994

Mr. Chairman, I want to thank you for holding these hearings, and for your support in addressing the problems confronting the defined-benefit pension system and the Pension Benefit Guaranty Corporation (PBGC).

I also want to commend Secretary Reich, and the other representatives of the Clinton Administration here today for their commitment, dedication, and leadership in developing the Retirement Protection Act of 1993.

I would also note that during the past two years the Subcommittee on Oversight has held five hearings on the problems confronting the PBGC and the defined-benefit pension system. Throughout this period, on a bipartisan basis, the Subcommittee has consistently supported measures to address these problems.

Mr. Chairman, I think it is important that we all recognize the current system is seriously flawed. Under current law, companies can avoid current adequate funding of their plans. Further, under the current premium structure administered by the PBGC, the premiums paid by companies with seriously underfunded plans do not reflect the risk these plans pose to the agency. As a result, a small but significant number of companies have utilized this system to their advantage while shortchanging their workers of secured retirement benefits and exposing the PBGC and ultimately the American taxpayer to additional liabilities.

Today, the PBGC guarantees over $53 billion in unfunded pension promises made by single-employer pension plans. Of this unfunded liability, the PBGC estimates that over $13 billion will very likely be a real liability for the agency. The PBGC presently has a deficit of $2.8 billion, in its single-employee program, as the result of claims it has already accepted. In recent years, the unfunded liability and PBGC's deficit have increased dramatically, and this growth shows no sign of abating.

Mr. Chairman, let me also note that the PBGC does not face immediate collapse. However, the PBGC, the General Accounting Office, and the Congressional Budget Office have all testified that unless reforms are enacted, this situation will continue to worsen, and will at some point require a Congressional bailout. There is no excuse for allowing a small number of plans to continue to abuse our current system for their own advantage while placing workers, retirees, other responsible plan sponsors, and taxpayers at risk.

Finally, Mr. Chairman, let me note that there is a

bipartisan recognition of the need for reform. In 1992, the Bush Administration sent its own reform proposal to Congress recognizing the need for legislation which would require companies to better fund their pension promises. In 1993, I was pleased to see that the Clinton Administration acted quickly in assembling a task force on these issues and in sending its recommendations for reform to the Congress.

Of course this bill is not popular with those companies who have consistently underfunded their pension plans in the twenty years since the passage of the Employee Retirement Income Security Act. I am sure that those who have taken advantage of the current system will ask the Congress to go easy on them. They will plead financial hardship and ask for relief. I only ask that we all remember that these companies will always find it easier to let somebody else be responsible for their unfunded pension promises. And who better than Uncle Sam? However, as the Members of this Committee know all too well, when it is time to pay for any Federal bailout, our constituents are the ones who will get the bill. I am sure no one on this Committee wants to repeat the experiences we have had in bailing out the failed Savings and Loan system, and, more recently, the retiree health plans of the United Mine Workers.

If we act responsibly now, we can restore PBGC's solvency, we can better protect the retirement plans of workers, we can encourage the vast majority of companies who have behaved responsibly to continue to offer their workers the advantages of defined-benefit pension plans, and we can protect the American taxpayer. In my judgment, under the leadership of the Secretary of Labor, the Administration has proposed responsible legislation which deserves our full support. I commend the Secretary again for his leadership. I urge prompt Committee and Congressional action on this legislation that is before us today.

Chairman ROSTENKOWSKI. Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, in 1974 you and I were on this committee when PBGC was developed. I remember the interest that I played in it at that time and there are some changes now that I wish we had been smart enough to foresee back in 1974.

One, there should certainly be no change in benefits in any of these plans, no increase in benefits certainly unless the PBGC signs off saying that they are fiscally sound. And two, there should be no reduction in the required contribution to these plans unless the PBGC signs off and says that they are fiscally sound.

These are just the minimum changes that I think ought to be made. I commend the administration and Mr. Pickle and the others who participated in this. We need to get this done. The security of these pension plans is of utmost importance to the workers today and we need to move ahead.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Gibbons. Our first witnesses are Hon. Robert Reich, Secretary of Labor, Hon. Leslie Samuels, Assistant Secretary for Tax Policy, and Hon. Martin Slate, Executive Director of the PBGC.

If you would, Mr. Secretary, begin the testimony. We would like for to you identify yourself for the record and then proceed into your testimony.

STATEMENT OF HON. ROBERT B. REICH, SECRETARY, U.S. DEPARTMENT OF LABOR

Secretary REICH. Yes, thank you, Mr. Chairman, members of the committee. My name is Robert Reich. I am Secretary of Labor. With me are on my right, Leslie Samuels, Assistant Secretary for Tax Policy, the Department of the Treasury and on my left, Martin Slate, Executive Director of the Pension Benefit Guaranty Corporation.

I am very pleased to appear before you today to discuss the administration's pension reform proposals to ensure the retirement security of American workers. Mr. Chairman, I want to tell you that I greatly appreciate your leadership on this issue and the leadership that you and the committee have brought to this issue.

This is extraordinarily important for American workers. Mr. Pickle, as I said to you before informally, I want to thank you for your tenacity with regard to this issue, for your commitment to this, with other members of the Oversight Committee, and also for your longstanding attention to the issue of pension protection.

We share your view that this is the time for reform. If there was ever a time for reform, now is the time. The economy is recovering. This is a good time to do it. Companies can afford to do it.

Now, when this administration came into office, we heard your warnings about the health of the pension system. I promised right away in my confirmation hearing on the Senate side that I would commence immediately to do something about it, to convene a task force composed of officials from the Treasury, Labor and Commerce Departments, and other experts, and that we would come up with a bill. We have.

We immediately set up an interagency task force to address the problem. The administration's legislative package, the Retirement

Protection Act, we believe, is a comprehensive, balanced and reasonable approach to this serious and growing problem. It is not yet a crisis, but it is serious. It is cause for concern.

Now, we are approaching the 20th anniversary of the Employee Retirement Income Security Act of 1974. This is the anchor of the private pension system. In those 20 years, the private pension system has become an American success story. We ought to be very proud of it. You ought to be proud—we ought to be proud of what we have achieved.

Thanks to ERISA, millions of hard-working Americans have gained pension coverage and those who were already covered have found that the promise of a benefit upon retirement has become a reality. And for many people, income from the pension spells the difference between just scraping by and actually having a comfortable retirement.

A mainstay of our private retirement system is something called the defined benefit pension plan, a kind that offers preset benefits to workers. These plans have enhanced productivity and stability in American industry, in addition to providing retirement security for its workers.

The Pension Benefit Guaranty Corporation, which I chair, plays an important role in safeguarding this entire retirement system. It guarantees the benefits of 41 million American workers and retirees in more than 65,000 pension plans. This agency, the PBGC, stands behind the promises of defined benefit-plans and assures that most benefits will, in fact, be paid to the workers who depend on them even if it turns out the company cannot fulfill its promises.

In fact, today, more than 346,000 American workers directly depend upon the Pension Benefit Guaranty Corporation for their pensions. It is the backdrop, the fail-safe device. Those who are in our trust will continue to receive their benefits, now and in the future. For them as well as for others, we have got to keep the Pension Benefit Guaranty Corporation on a sound and strong footing.

Now, here is the problem. Most of the pension plans insured by the PBGC are well funded. The retirement system in general is a strong one, but there are growing problems, there are growing chinks in the armor. Underfunding of pensions is persistent.

In the last few years, underfunding has nearly doubled. In 1987, we had $27 billion of underfunding, and that was bad. It was not critical. In 1992, the last year for which we have the data, we had $53 billion in underfunding. This is a doubling of the underfunding problem.

This chronic underfunding can potentially undermine our retirement system. It is vitally important that we move now.

Underfunding is concentrated in a few industries such as steel, automobile, tire, manufacturing and airlines. Underfunding poses an unnecessary and unacceptable risk for workers and retirees. If their plans should terminate, they may lose benefits not covered by the PBGC guarantee.

These underfunded plans also obviously pose a risk to the Pension Benefit Guaranty Corporation. Just last week, the PBGC announced that its deficit now approaches $2.9 billion. That deficit for

the PBGC is moving us in a direction that could have significant consequences.

Again, I want to emphasize, we are not in crisis, but there is reason to be seriously concerned. We have got to do something about this now.

At the same time, the insurance program, with more than $8 billion in assets, is not in immediate danger. Because PBGC's payments are spread out over many years, it can continue to pay benefits for a long time. So long as chronic underfunding persists, however, and continues to get worse, the long-term health of the Nation's pension system and the insurance program that protects it is uncertain.

Now is the time to act, to enact the pension reforms under the Retirement Protection Act. The growing trends in underfunding and the PBGC deficit as well are clear; they are irrefutable, and they must be reversed.

We want to issue a very clear, unambiguous warning. It is simple common sense to deal with these problems while they are still manageable. When the economy is coming out of recession, it is the best time for companies to fully fund their pension plans. We can not, must not, stand by and watch while the situation worsens. If the economy someday in the future should go down into recession again, we will have serious, serious problems on our hands.

Underfunding is not going to disappear of its own accord. Much of the buildup in underfunding is due to too much flexibility in our funding rules for those who wish to minimize contributions. Some employers, in fact, operating within the framework of current law, have been able to take contribution holidays, just stop contributing, even though their plans are severely underfunded.

Underfunding will continue unless we close the avenues for companies to legally avoid their funding responsibilities.

Our solutions, if pursued now, are both reasonable and affordable. If we wait, the medicine is only going to get stronger. It is going to be less and less palatable. We have to take advantage of today's growing economy to put an end to the problem, to put the Nation's defined-benefit system on a sound footing.

This proposal, the Retirement Protection Act, is the result of a task force put together last year to address these concerns. It guarantees faster and more certain funding and would guarantee increased contributions to underfunded plans. If enacted, this legislation will eliminate the problem of chronic underfunding.

This legislation is designed to fix only what is broken. We don't want to overreach. This is a careful balance here. The fully funded plans would not be affected by our major reforms. We feel this is comprehensive, this is balanced. It will protect the pension benefits of American workers and retirees, while at the same time allow companies to continue in business, provide jobs, contribute to the economy.

There are four principles, simple principles that undergird this proposal. No. 1, funding. Strengthening the funding rules is at the heart of the reform package. Current law permits as long as 30 years in some instances for companies to fund promised benefits. Given business realities, that is simply too long.

We accelerate contributions to underfunded plans, and we eliminate the wiggle room that employers now have under current law to avoid funding their plans. This should result in most new benefits being funded over 5 to 7 years.

Now, we also obviously want companies to move forward with their businesses. We don't want to unduly handicap companies. Thus we have included in the legislation a special transition rule in order to protect employers from extraordinary increases in their annual contributions for up to 7 years.

No. 2, PBGC compliance authority. The reforms also make important changes in the compliance authority PBGC has. We have to make sure that PBGC has the tools to effectively enforce the law and to assure that large employers remain responsible for their pension plans.

Our proposals would require that companies with large underfunded plans provide the PBGC with advance notice of certain transactions. When these transactions threaten the long-term life and the health of the pensions, PBGC would be allowed to apply to the Federal courts for remedies other than plan termination.

In other words, we don't want companies to be able to simply cut off their most severely underfunded components and essentially put them out to sea. The proposals are carefully tailored to assure the continued pace of corporate transactions.

No. 3, premiums. To further encourage better funding, we propose to phase out the cap on the variable rate premium paid by sponsors of underfunded plans.

Plans that pose the greatest risk obviously should pay their fair share. At present, companies with 80 percent of the underfunding pay only a quarter of PBGC's total premium income. Now, that is simply unfair. That is inequitable and that does not create the proper incentives. Under this proposal, these companies would pay half.

Finally, participant assistance. We will require employers with underfunded plans to provide their workers in plain language with information on the plan's funding and on the limitations of the PBGC guarantees. Let me emphasize that this information is to be in plain language that workers can understand, comprehend and read. Those of you who are ERISA experts in this committee know how complicated this can be.

Workers have every right to know whether their pensions are at risk. Only then can they make informed choices about their retirements and their futures.

Let me just conclude by saying that this is a strong, integrated package, and it is carefully crafted. Mr. Chairman, members of the committee, we need these reforms because current law is simply not working. Pension underfunding has swollen substantially since 1987, and the legal loopholes that I have outlined are putting workers, retirees, and the American taxpayer at risk.

The Retirement Protection Act takes a firm and balanced approach, strengthening our defined benefit pension system and improving the PBGC's ability to protect it. The reforms will assure funding of all vested benefits within 15 years and, based on prior experience of the Pension Benefit Guaranty Corporation, it will eliminate PBGC's deficit within 10 years.

The time to fix the retirement system is now. The administration stands ready to work with you, ready to work with Congress to expedite passage of this very important piece of legislation.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF THE TREASURY

Chairman ROSTENKOWSKI. Mr. Samuels.

Mr. SAMUELS. Mr. Chairman and members of the committee, I would ask that my written statement be placed in the record——

Chairman ROSTENKOWSKI. Without objection, all the statements in their entirety will be included in the record, if you care to summarize.

Mr. SAMUELS. Thank you. The Treasury Department actively participated in the administration's PBGC task force, and the Department strongly supports this package. We believe that this legislation addresses the primary causes of PBGC deficits in a responsible manner and before the situation becomes a crisis.

This morning, I will discuss the portions of the bill that amend the Internal Revenue Code.

Before I begin my remarks, I would like to echo the comments of Secretary Reich and acknowledge the efforts of Mr. Pickle and the Subcommittee on Oversight, and you, Mr. Chairman, in helping to focus the debate on PBGC's potential liability.

Most of the amendments to the Internal Revenue Code in this legislation relate to the minimum funding rules. These minimum funding rules are designed to ensure that employers sponsoring defined-benefit plans set aside assets to secure the promised benefits.

The minimum funding rules as amended in 1987 require a large employer that sponsors an underfunded plan to make additional deficit reduction contributions in order to eliminate the underfunding more rapidly. In reviewing the effectiveness of these rules, we determined that some employers with significantly underfunded plans had found loopholes in the statute. The bill modifies these funding rules in several ways.

First, the bill improves the coordination of the deficit reduction contribution and the regular minimum funding determinations. Second, the bill mandates the use of certain standard assumptions for purposes of determining the deficit reduction contribution. Third, the bill tightens the formula that determines the speed of funding new liabilities. This change will ensure that increases in liability from benefit improvements will be funded over a period that more closely tracks the 5-year phasein of PBGC's guarantee.

Finally, we have tried to close potential loopholes in advance. For example, the bill provides that certain employers sponsoring large underfunded pension plans would be required to obtain advance IRS approval of changes in assumptions that significantly decrease their current liability.

The administration recognizes that an abrupt increase in the minimum funding requirements may be overly burdensome for employers in the short term. Consequently, the bill includes transition

rules that give short-term relief to employers while still providing for steady, gradual improvement in plan funding.

In reviewing the funding rules, we identified two provisions that could benefit taxpayers by narrowing the scope of their application: The quarterly contribution requirements and the excise tax on nondeductible contributions.

The requirement that an employer make quarterly contributions to its pension plan provides an early warning signal for the PBGC that an employer may be unable to meet the minimum funding requirements for a year. On the other hand, the requirement that an employer contribute four times a year adds an administrative burden.

Where plan assets exceed current liabilities, the administrative burden on employers outweighs the benefit to employees and the government. The bill would eliminate the quarterly contribution requirement in these cases.

The purpose of the excise tax on nondeductible contributions is to discourage employers from transferring assets into the plan's tax-exempt trust. The bill creates exemptions to the excise tax in situations where the employer's nondeductible contributions are not motivated by a desire to obtain excessive tax shelter.

Now, I would like to discuss the rounding rules for indexed values. Many of the statutory dollar thresholds and limits used in the qualified plan area are indexed to changes in the cost of living. The bill would change the indexing rules so that the new values for a year are available before the start of the year and would specify that the index values are rounded to even multiples of $500 in the case of section 401(k) plan limits or $5,000 in other cases.

These proposals would simplify administration by employers and communication with employees. The proposal also raises revenue to offset some costs of the bill.

Finally, let me turn to a nondiscrimination issue. As a condition of tax favored treatment, section 401(a)(4) of the Internal Revenue Code requires that retirement plans demonstrate that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees.

This demonstration can be on the basis of either contributions or benefits without regard to whether the plan is a defined contribution plan or a defined-benefit plan. The bill would generally prohibit the practice known as cost testing a qualified defined-contribution plan on the basis of the benefits it is expected to provide.

Creative practitioners have recently developed aggressive plan designs that provide more contributions for highly-paid employees than for everyone else and demonstrated compliance with the nondiscrimination rules by cross testing. The potential for highly compensated employees receiving substantial benefits in cost-tested plans has received considerable press attention.

These press reports emphasize that highly-paid employees can maximize benefits for themselves while minimizing contributions for the rank and file workers.

For example, a June 1993 financial planning article is headlined, "Skewed Retirement Plans Help Owners at Workers' Expense." This same article concludes that these plans, "May shine brightest

for the business owner client who is truly out for himself and isn't concerned with employee retention."

Then the Wall Street Journal leads its story with, "Is it a retirement plan or a tax shelter?" And finally, the March 1994 Journal of the American Society of Chartered Life Underwriters contains an illustration of an employer using cross testing to reduce the allocations for rank and file workers from 15 percent of pay to 3 percent of pay, while the owner continues to receive the maximum allocation of $30,000.

The administration is concerned that these practices reduce the share of tax-subsidized retirement funds that go to rank and file workers and can encourage employers to abandon the defined-benefit system, thus eroding the PBGC premium base.

Since the administration proposed limiting cross testing, we have discussed the issue with many plan sponsors, advisors, and industry groups. We have actively solicited comments on the effect the proposal might have on those plans that provide significant benefits to rank and file workers as compared to the abusive cases.

We have received useful suggestions in this regard and we wish to work with the committee in tailoring a proposal to target only the troublesome cases.

In this process, however, our guiding principle remains the recently developed abusive practices must stop.

In conclusion, I would like to emphasize that now is the time to act while the PBGC's problems are still manageable. Enactment of the Retirement Protection Act of 1993 will require employers sponsoring defined-benefit plans to do a better job of satisfying their commitments by adequately funding their plans, thereby reducing PBGC's potential liability.

Mr. Chairman, this completes my statement.

Chairman ROSTENKOWSKI. Thank you, Mr. Samuels.

[The prepared statement and attachments follow:]

For Release Upon Delivery
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April 19, 1994

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on the Retirement Protection Act of 1993 (H.R. 3396). The Treasury Department actively participated in the Administration's PBGC Task Force and the Department strongly supports this package. We believe that this legislation addresses the primary causes of the recent trend of losses for the Pension Benefit Guaranty Corporation (PBGC) and that enactment of the legislation would reverse the trend of increasing PBGC deficits in a responsible manner, before the situation becomes a crisis. This morning I will discuss the portions of the bill that amend the Internal Revenue Code.

Minimum funding requirements

The bulk of the amendments to the Internal Revenue Code in this legislation relate to the minimum funding rules that are found in section 412. These minimum funding rules are designed to ensure that employers sponsoring defined benefit plans set aside assets to secure the benefit promise made to their employees. In recognition of the long-term nature of the liabilities, the minimum funding rules permit employers to fund their commitment over a number of years.

The minimum funding rules enacted as part of the Employee Retirement Income Security Act of 1974 (ERISA) were amended in 1987. These amendments require an employer with over 100 employees that sponsors an underfunded plan to make an additional deficit reduction contribution designed to eliminate the underfunding more rapidly. In reviewing the effectiveness of these rules, the Administration's task force determined that some employers with significantly underfunded plans had used loopholes in the statute that allowed them to avoid making these additional deficit reduction contributions.

The bill modifies the deficit reduction contribution requirements in a number of ways in order to close the statutory loopholes that employers have exploited. First, the bill improves the coordination of the deficit reduction contribution and the regular minimum funding determinations. Under current law, the impact of actuarial gains and reductions in liability due to changes in actuarial assumptions (or in the other direction, the impact of actuarial losses and increases in liability due to changes in actuarial assumptions) is recognized twice in determining the deficit reduction contribution The bill would end this double counting and effectively require the employer to make contributions based on the greater of the regular minimum funding requirement and a free-standing deficit reduction contribution.

Secondly, the bill mandates the use of certain standard assumptions for purposes of determining the amount of a pension plan's underfunding and the amount of the resulting deficit reduction contribution. The 1987 rules required the use of an interest rate within the corridor of 90-110% of the interest rate on 30-year Treasury bonds (averaged over the past four years) for this purpose. However, the 1987 rules did not require the use of any particular mortality table for this purpose. As a result, employers with poorly funded pension plans have had an incentive to use interest rates at the high end of the permitted corridor and to assume that their employees have higher than usual mortality (i.e., lower life expectancy). The use of high interest rates and mortality assumptions minimizes the amount of the apparent pension liability, reducing the required contributions.

The Retirement Protection Act would mandate that the interest rate used for purposes of determining the deficit reduction contribution be no greater than 100% of the 30-year Treasury rates (7.30% for plan years beginning in April 1994) and would require the use of the group annuity mortality table currently adopted by the insurance commissioners of at least 26 States. As the Members of this Committee know, this is the same mortality table specified in Internal Revenue Code Section 807(d)(5), relating to the determination of reserves for life insurance companies.

The bill would also tighten the deficit reduction contribution formula that determines the speed of funding new plan liabilities under the 1987 amendments. The new formula would require plans to fund substantially all of the increases in liability in the first 5-7 years after the amendment. Under current law, the liablity can be funded at a rate that corresponds to 12 year amortization. This change will ensure that increases in liability from benefit changes will be funded over a period that more closely tracks the five-year phase-in of PBGC's guaranty.

Finally, in developing the proposal we attempted to anticipate how employers might try to avoid making deficit reduction contributions in the future, and then we closed these potential loopholes in advance. For example, the bill provides that employers sponsoring significantly underfunded pension plans (i.e., over $50 million of underfunding in the controlled group) would be required to obtain advance Internal Revenue Service approval of changes in actuarial assumptions that significantly decrease their current liability. Thus, while these employers will be permitted to reflect their individual situations in establishing retirement age assumptions, for example, they would need to justify to the I.R.S. any changes in those assumptions from prior assumptions. This requirement, in conjunction with the use of a specified mortality table and a lower cap on the interest rate, will ensure that employers cannot manipulate the plan's actuarial assumptions to avoid their responsibility to fund their benefit promises.

The Administration recognized that an abrupt increase in the minimum funding requirements may be overly burdensome for employers in the short term. Consequently, the bill includes transition rules that give short-term relief to employers, while still providing for steady, gradual improvement in plan funding.

Quarterly contributions and nondeductible contributions

As part of the process of reviewing the funding rules, the task force identified two other related provisions that we believed could be improved by narrowing the scope of their application: the quarterly contribution requirements and the excise tax on nondeductible contributions. I will discuss each of these provisions in turn.

The requirement that an employer make quarterly contributions to its pension plan (modeled on the payment of estimated income tax) was added in 1987 and provides an early warning signal for the PBGC that an employer may be unable to meet the minimum funding requirements for a year. In the absence of the quarterly contribution requirement, such an employer could wait until 20 1/2 months after the beginning of the plan year before coming to grips with its financial responsibility to the plan. By requiring quarterly contributions, and notice to the PBGC and plan participants of an employer's failure to pay these installments, the funding rules force the employer to face up to its problems earlier in the year.

The quarterly contribution rules also are beneficial in the situation where the employer's financial problems first appear later in the plan year. In this case, if the employer has been making the required quarterly installments a plan will have been at least partially funded during the portion of the year prior to the development of the financial problems.

On the other hand, the requirement that an employer contribute four times a year, together with the need to have an actuary determine the minimum installments, adds an administrative burden for an employer. If a plan currently has assets in excess of its current liability, the Task Force concluded that the administrative burden on employers outweighs the benefit of quarterly installments to the employees and the Government. This is particularly true for plans near the full funding limit, where an employer that must make a quarterly contribution before the actuarial valuation is complete may ultimately discover that the contribution is nondeductible. For these reasons, the bill would eliminate the quarterly contribution requirement for plans that had assets in excess of current liability in the previous year.

The purpose of the excise tax on nondeductible contributions is to discourage employers from making these contributions in order to transfer assets into the plan's tax-exempt trust. In the two situations described in the bill, we believe that the employer's nondeductible contributions are not motivated by a desire to obtain excessive tax shelter, but are primarily a result of non-tax considerations, and should not generate an excise tax. These situations arise where: 1) an employer with fewer than 100 employees contributes an amount to its pension plan to fund the current liability and then terminates the plan, or 2) an employer sponsoring a defined benefit plan also sponsors a section 401(k) plan with overlapping coverage that is receiving employee salary deferrals or employer matching contributions totaling less than 6 % of compensation. In the former case, a small employer may be required to make the nondeductible contributions as a condition of plan termination. The latter case deals with the anomalous situation where an employer wishes to make additional contributions in order to decrease plan underfunding, but is now discouraged from doing so because employees are electing to make salary deferrals in a 401(k) plan that count against the employer's aggregate qualified plan deduction limits.

Actuarial equivalence

The bill makes minor changes to the actuarial equivalence rules used for purposes of converting annuities to nonannuity distributions, primarily lump sums, under sections 417(e) (restrictions on cash-outs) and 415(b) (maximum permitted benefits). Under current law, the actuarial equivalence that can be used for these purposes is based on two different interest rates (one of which is tied to the PBGC interest rates used to value terminated plans, the other of which can be as low as 5%) and no specified mortality table. The bill would specify a single interest rate and mortality table for both purposes. Eliminating the current cross-reference to the PBGC interest rates will also enable the PBGC to adjust the interest rate it uses for other purposes in the future without also affecting the benefits of participants in all plans.

Nondiscrimination and Cross-testing

As a condition of tax-favored treatment, section 401(a)(4) requires that retirement plans demonstrate that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. Under current law, this demonstration can be on the basis of either contributions or benefits, without regard to whether the plan is a defined contribution plan or a defined benefit plan.

Section 408 of the bill would generally prohibit the practice known as "cross-testing" a qualified defined contribution plan. The bill would generally require defined contribution plans, and aggregations of defined contribution and defined benefit plans, to demonstrate nondiscrimination on the basis of actual plan contributions, as opposed to projected benefits at retirement.

Cross-testing a defined contribution plan is needed when plans provide different allocations, as a percentage of compensation, to different employees. If the employees receiving larger allocations are older than the other employees, the difference may be justified by looking at the equivalent benefits those allocations are projected to generate. While some argue that cross-tested defined contribution plans merely make explicit the age-bias that is implicitly found in traditional defined benefit plans, there are significant differences between these types of plans. For example, the amount of benefit an employee receives from a defined benefit plan does not depend on the investment return in the fund; and the delivery of that benefit is further guaranteed by the PBGC. However, employees in a cross-tested defined contribution plan bear investment risk. An employee will receive the hypothetical benefit that is used to satisfy the nondiscrimination rules only if the plan's investment return and the conversion of the employee's account balance into retirement income actually match the assumptions used in the projection.

Creative practitioners have recently gone further than merely mimicking the distributional aspects of defined benefit plans by relating allocations to age. They have developed aggressive plan designs that provide significantly higher contributions for one class of employees (such as the owners of a business) than for the rest of the employees. If most of the favored class is older than the other employees, as is often the case in these situations, cross-testing may be used to satisfy the nondiscrimination rules in an inappropriate way.

The potential for highly-compensated employees receiving substantial benefits in cross-tested plans has received considerable press attention. For example, discussions of cross-testing have made their way into the Wall Street Journal, Pension World and Financial Planning magazine. These articles emphasize the potential for highly-compensated employees to maximize benefits for themselves while minimizing contributions for rank-and-file workers. For example, a June 1993 Financial Planning article is headlined "Skewed retirement plans help owners at workers' expense." The Wall Street Journal article leads with the question "Is it a retirement plan , or a tax shelter ?" An article in the March 1994 Journal of the American Society of CLU and ChFC contains an illustration of an employer using cross-testing to reduce the allocations for rank-and-file workers from 15% of pay to 3% of pay, while the owner continues to receive an allocation of $30,000. I have attached copies of a small collection of these articles for the record.

The Administration is concerned that such practices and the increasing attention that they have been receiving, can

- reduce the share of tax-subsidized retirement funds that benefit rank-and-file workers

- encourage employers to abandon the defined benefit system, thus eroding the PBGC premium base

- discourage the hiring of older rank-and-file workers (to the extent that ADEA doesn't protect these workers), and

- generally have a detrimental impact on the public's perception of the integrity of our tax-favored retirement system.

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- reduce the share of tax-subsidized retirement funds that benefit rank-and-file workers
- encourage employers to abandon the defined benefit system, thus eroding the PBGC premium base
- discourage the hiring of older rank-and-file workers (to the extent that ADEA doesn't protect these workers), and
- generally have a detrimental impact on the public's perception of the integrity of our tax-favored retirement system.

For these reasons, the Administration supports the ban on cross-testing provided in the bill.

Let me emphasize that this proposal was developed because some employers are manipulating the cross-testing rules in order to obtain a tax subsidy for retirement plans that provide excessive contributions to highly compensated employees, at the expense of rank-and-file workers. Since the Administration proposed limiting cross-testing, we have discussed the issue with a wide array of plan sponsors, advisors and industry groups. We have actively solicited comments on the effect the proposal might have on those plans that provide significant benefits to rank-and-file workers, and we have asked how the law could distinguish those plans from those abusive cases. We have received useful suggestions in this regard and wish to work with the Committee in tailoring the proposal to target only the abusive cases. In this process, however, our guiding principle remains -- the abusive practices must stop.

Rounding rules for indexed values

Many of the statutory dollar thresholds and limits used in the qualified plan area are indexed to changes in the cost of living. For example, the annual limit on contributions under section 401(k) is $9,240 in 1994 (increased from $8,994 in 1993). The bill would change the indexing rules so that the indexed values for a year are available before the start of the year and would provide for rounding of these indexed values to the next lowest multiple of $500 or $5,000. The earlier determination of the indexed values and the use of rounded values would simplify administration by employers and communication with employees, because the indexed values would not necessarily change each year. The proposal also has the effect of raising revenue to offset some costs of the bill. As the Members of the Committee know, a similar rounding rule was adopted in last year's reconciliation bill for the compensation limit of section 401(a)(17).

Conclusion

In conclusion, I would like to emphasize that now is the time to act, while the PBGC's problems are still manageable. Although the PBGC has assumed significant liabilities over the past ten years from the termination of underfunded plans, PBGC's responsibility for benefit payments under those plans is spread out over a number of years. Enactment of the Retirement Protection Act of 1993 will require employers sponsoring defined benefit plans to do a better job of living up to their commitments by adequately funding their plans, thereby reducing PBGC's potential liability.

"New Comparability": Increased Flexibility for Profit Sharing Plans?

EDWARD F. LONDERGAN
PAUL VICKERS, ChFC, FLMI

Abstract: *The ability of employers to develop increasingly flexible qualified retirement plans has evolved from integrated allocation plans to age-weighted plan: and now, to "new comparability" plans. In the authors' view, new comparability gives employers an opportunity to make the bulk of their retirement plan contributions to key employees — and still pass nondiscrimination tests. The authors show that they believe new comparability is even more flexible than age-weighting. They also note that pending legislation could affect the use of new comparability, but that the fate of the legislation is unknown at this time.*

While recognizing the advantages of profit sharing plans, many employers would prefer to have more control over the benefits they provide. Many plan sponsors, for example, would like to be able to design a plan that is flexible enough to reward key employees — those who contribute most to profits. Businesses that offer their employees a 401(k) plan often are looking for a supplemental plan that allows them to maximize their own annual contributions without giving up tax advantages.

A profit sharing plan design called "new comparability" gives many employers the flexibility to structure their profit sharing plans to meet these and other needs. New comparability allows many employers to contribute the maximum $30,000 a year for themselves and the minimum three percent of pay for other employees — and still pass nondiscrimination tests. In other words, new comparability plans are nearly as flexible as nonqualified plans, but offer the tax benefits of qualified plans.

Unless an employer receives a greater financial benefit from a profit sharing plan than he or she would receive by simply including the money as taxable earnings, the employer is unlikely to go to the trouble of establishing a plan. That's why, for as long as profit sharing plans have existed, planning experts have searched for designs that maximize the percentage of contributions allowed for preferred employees, while still meeting the criteria necessary for a plan to qualify for federal tax benefits. To be qualified, the plan has to pass tests that determine whether it discriminates against non-highly-compensated employees.

So the challenge to plan designers is to develop plans with seemingly contradictory goals — the plan has to pass nondiscrimination tests while at the same time providing the bulk of the plan benefits to highly-compensated employees.

The first design to address this challenge was the integrated allocation plan, which takes social security contributions into account in calculating contributions on after-tax income. Integrated plans proved effective until the Tax Reform Act of 1986 became law. Before the Tax Reform Act, a spread of 30 percent was allowed between contribution rates for highly-compensated and non-highly-compensated employees. The Act reduced the allowable spread to 5.7 percent.

Age-Weighted Plans

The next major advance toward achieving employer goals came when regulations for Section 401(a)(4) of the Internal Revenue Code were issued in 1991. These regulations, which are more than 600 pages long, allow defined contribution plans, including profit sharing plans, to base nondiscrimination testing on benefits provided at retirement instead of on annual contributions.

As a result of the new regulations, many employers are allowed to "age weight" their plans — an advantage previously allowed only with defined benefit plans. Defined benefit plans have decreased in popularity, especially among small employers, because of their lack of flexibility, and because the proliferation of regulations in recent years has made them administratively burdensome.

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New comparability gets its name because it gives employers a new way to compare groups of employees for nondiscrimination testing.

Age-weighting gives employers the ability to make contributions based on the concept that older employees should receive larger contributions each year, because they are closer to retirement and therefore have a shorter funding period. Because the business owner and key executives often are older than other employees, age-weighting allows the plan to be designed to favor them. Understanding new comparability requires an understanding of age-weighting because it is based on the same concept and is even referred to by some experts as "advanced age-weighting."

Age-weighted plans test for nondiscrimination based on benefits provided, instead of contributions allocated. First, the allocation for each participant is projected to retirement age at a reasonable rate of interest (8.5 percent is typically used). The resulting lump sum is converted to an annuity, based on reasonable assumptions (i.e., 8.5 percent interest and UP-84 mortality). The annuity is expressed as a percentage of compensation, which is called the "equivalent benefit accrual rate," or EBAR. The EBAR is then used for all discrimination testing.

Consider, for example, a 55-year-old with a $100,000 salary and a $20,000 annual account addition this year. Projecting $20,000 at 8.5 percent interest for 10 years, assuming a retirement age of 65, yields $45,220. It takes $10.48 at 8.5 percent interest to create annual income of $1, so the employee's annual income from the plan is $45,220/$10.48, or $4,314.85. Since his salary is $100,000, his EBAR is $4,314.85/$100,000, or 4.31 percent.

When EBARs are used for discrimination testing, older employees receive larger annual contributions as a percentage of pay, since their EBAR is based on fewer years of earnings growth. Before age-weighting was allowed, an employer approaching retirement conceivably had to contribute more to younger employees' retirement plans over their careers than to his or her own account, since the employer would receive benefits for fewer years. For example, a business owner receiving the maximum $30,000 a year with five years to retirement hypothetically would receive less at retirement than a 30-year-old employee receiving $5,000 a year would receive at retirement, assuming the plan continued after the business owner's retirement.

Age-weighting allows employers to skew benefits in favor of older employees, but it does not always produce the desired results. For example, with an age-weighted plan, a 60-year-old clerical worker may receive a greater benefit than the employer would like to provide, while a 30-year-old company owner may receive a smaller benefit than desired. Age-weighting also creates potential problems for partnerships. Consider, for example, a two-person partnership where the partners are 35 and 50. Age-weighting would give the older partner an annual contribution more than twice as large as that of his partner.

New comparability addresses these issues. Because new comparability plans, like age-weighted plans, are based on aggregate projected benefits, it is still important that groups of highly-compensated individuals, as a whole, be older than groups of non-highly-compensated individuals if the plan is to work to the employer's advantage. However, when using new comparability, the age of one employee is less likely to throw off testing results.

New comparability regulations can be applied to all types of retirement plans, but in most cases they are likely to be used with profit sharing plans. Employers who are looking for flexibility will find that a new comparability plan is most flexible when it is set up as a profit sharing plan, since profit sharing plans allow employers to reduce or even eliminate contributions during years when the company has little or no profits.

What Is New Comparability?

Regulations covering Section 401(a)(4) allow the creation of not only age-weighted profit sharing plans, but also new comparability plans. Although the regulations have existed since September 1991, most employee benefits experts either do not know about new comparability or are cautious about using it. However, the use of new comparability should increase significantly following a recent IRS interpretation confirming that new comparability is allowable under the regulations as they currently exist.

So exactly what is new comparability? New comparability gets its name because it gives employers a new way to compare groups of employees for nondiscrimination testing. But it is based on a concept that isn't so new. It relies on cross-testing, which was developed in 1981.[1] Typically, the participants in the plan are divided into classes, and then a separate contribution is made for each class. Within a class, the contribution is allocated uniformly (either as a flat dollar amount or as a percentage of pay). The classes may be based on any reasonable criteria (percentage of ownership, status as key or highly-compensated employees, job description, length of service, etc.). Cross-testing is then used to demonstrate that the resultant allocation complies with nondiscrimination rules.[2] As with age-weighted plans, the allocation for each participant is projected to retirement age and converted to an EBAR.

With new comparability, Section 410(b) nondiscrimination testing is satisfied by dividing employees into

"New Comparability": Increased Flexibility for Profit Sharing Plans?

"rate groups." Each highly-compensated employee, as defined by Code Section 414(q), determines a separate rate group. The group consists of that employee, and all others with an EBAR equal to or greater than his or hers. If each rate group satisfies 410(b) requirements, the allocation as a whole passes the Section 401(a)(4) test.

A new comparability plan provides the employer with more control than any other plan. The employer can design a new comparability plan that chooses precisely which employees will be rewarded and how much they will receive, based on how he or she sets up the rate groups. For example, one small business owner was able to contribute $30.000 a year to his plan while limiting contributions for his six employees to just three percent of pay.

Consider a company that has highly-compensated employees with EBARs of 12.62 and 4.83, and non-highly-compensated employees with EBARs of 12.62, 2.06, 4.83 and 5.16. Group I would consist of the two employees with EBARs of 12.62. Group II would consist of the highly-compensated employee with an EBAR of 4.83 and the non-highly-compensated employees with EBARs of 4.83 and 5.16, in addition to both employees in Group I, since both employees in Group I have EBARs exceeding 4.83.

Each rate group must then pass 410(b) testing, using either the ratio percentage test or the two prongs of the average benefits test. For this example, the plan passes the average benefits test, but not the ratio percentage test. Using the ratio percentage test, the proportion of non-highly-compensated employees is divided by the proportion of highly-compensated employees in each group. Since Group I contains one of four non-highly-compensated employees and one of two highly-compensated employees, the ratio percentage is 1/4 divided by 1/2, or 50 percent. Since the ratio percentage must be at least 70 percent to pass the test, Group I does not pass the test.

Now let's try the average benefit test. To pass the first prong, nondiscriminatory classification, the ratio percentage for each rate group must be at least equal to the midpoint between the safe and unsafe harbors from the table included in the 410(b) regulations (see Figure 1), based on the plan's concentration percentage. The concentration percentage is obtained simply by dividing the number of non-highly-compensated employees, by the total number of employees. Employees excludable under 410(b), such as those failing to meet age and service requirements, or non-resident aliens or union employees, are not included in this (or any other) calculation.

Since the sample plan has a concentration percentage of 66.6 (4/6), a ratio percentage of 39.75 is needed.

Figure 1
Reg. 410(b)-4(c)(4)(iv)

Non-highly-Compensated Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Non-highly-Compensated Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

In some cases, traditional plans do not allow the employer enough of a financial advantage to make it worthwhile to establish a profit sharing plan.

based on the table included with 410(b) regulations. The first rate group has a ratio percentage of 50. Since 50 exceeds 39.75, Group I passes the test. The second group has three of the four non-highly-compensated employees and both of the highly-compensated employees, so it has a ratio percentage of (3/4)/(2/2), or 75 percent. Because 75 exceeds 39.75, it also satisfies the requirements. Since all rate groups pass, the nondiscriminatory classification test has been passed.

To pass the second prong, an average benefit rate must be calculated. It is calculated by computing the average EBAR for highly-compensated employees and the average EBAR for non-highly-compensated employees. To pass the test, the average benefit rate for non-highly-compensated employees must equal or exceed 70 percent of the average benefit rate for highly-compensated employees. In the example, the average EBAR for highly-compensated employees is (12.62 + 4.83)/2, or 8.73 percent. The average EBAR for non-highly-compensated employees is (12.62 + 2.06 + 4.83 + 5.16)/4, or 6.17 percent. Since 6.17/8.73 = 70.67 percent, the plan passes the test.

New Comparability Comparisons

The advantage of new comparability plans is best illustrated by comparing it with other plan designs. In the first example above, a business owner has five employees and wants to maximize his own contributions while minimizing contributions for other employees.

As Figure 2 shows, a new comparability plan allows the employer to maximize his contribution at $30,000, while contributing a total of just $2,792 for his five other employees. Expressed as a percentage, 91.5 percent of the total contribution remains with the employer. This allocation is arrived at by dividing the employees into two classes, owners and non-owners. A contribution of $30,000 for the owners class is declared, and a contribution of three percent of pay for the non-owners' class is declared. The results are as shown in Figure 2. An age-weighted plan provides the second most attractive alternative, with 85.5 percent of the total contribution remaining with the employer and 14.5 percent, or $5,092, going to other employees. With more traditional plans, contributions to employees increase significantly. With an integrated plan, employees receive $10,184, or 25.3 percent of the total. With a salary ratio plan, employees receive $13,962, or 31.8 percent of the total.

These figures are based on first-year contributions only. The advantages of new comparability are even more apparent when viewed over time. While contributions may not remain constant from year to year, for the sake of this example assume that they do, and that annual deposits earn six percent a year. When the employer retires in 11 years, he will have accumulated $506,098 for himself, compared with a total of $47,107 for other employees (Figure 3). Other employees would earn $85,897 using an age-weighted plan, $171,809 using an integrated plan, and $235,534 using a salary ratio plan. While the $188,000 difference between the new comparability plan and the salary ratio plan includes interest accumulated over 11 years, it is still clear that annual savings can be significant.

In some cases, traditional plans do not allow the employer enough of a financial advantage to make it worthwhile to establish a profit sharing plan. Consider, for example, a restaurateur with 30 employees who wants to contribute the maximum amount for herself and minimize contributions to other employees (see Figure 4). She retains only 27 percent of the total contribution under a salary ratio plan, with $29,772 for herself and $80,652 for other employees. Because she will not reach retirement for 22 years, even an age-weighted plan would not benefit her. To receive the $30,000 maximum, she would have to contribute $51,757, or 63.3 percent of total contributions, to other employees. Typically, employers will not set up a profit sharing plan unless

Figure 2

Comparison of Profit Sharing Plans

Employee	Age	Salary	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	54	$200,000	$30,000	$30,000	$30,000	$30,000
E1	20	10,500	1,575	1,149	315	315
E2	25	16,500	2,487	1,814	497	497
E3	38	15,000	2,250	1,641	610	450
E4	38	24,000	3,600	2,626	976	720
E5	49	27,000	4,050	2,954	2,693	810
Principal			30,000	30,000	30,000	30,000
Others			13,962	10,184	5,089	2,790

"New Comparability": Increased Flexibility for Profit Sharing Plans?

at least 70 percent of benefits go to preferred employees.

Using a new comparability plan, she is able to contribute $30,000 for herself and limit contributions to $17,254 for other employees. She retains 63.5 percent of the contribution, compared with just 27 percent using a traditional plan.

Again, a two-class approach was used — one class of owners, which received a $30,000 contribution, and one class of non-owners, which received a $17,254 contribution. Keep in mind that criteria other than ownership also could have been used to define the classes.

Advantages and Disadvantages

While these examples make the financial advantages of new comparability plans evident, other advantages also should be considered, including the following:

- Unlike age-weighted plans, which are most suited for small businesses, new comparability plans can be used effectively by medium-sized and even fairly large companies.
- They can be used with a 401(k) plan.
- They can be used to attract and retain employees with hard-to-find skills.
- If it is designed as a profit sharing plan, the employer retains the choice of whether to make a contribution in any given year.

As these advantages illustrate, new comparability is the ideal profit sharing plan for many businesses. However, it is not ideal for every business. Individual circumstances must be taken into account, and the following disadvantages should also be considered:

- Because they are tailored to small groups of employees within the company, they are sometimes more difficult and costly to develop than other plans, and may require more administration than many other defined contribution plans.
- New comparability plans must be monitored carefully and continually. Because they bring nondiscrimination testing to the limits, the departure of a single employee may push the company out of compliance.
- Though its impact is less significant than with age-weighted plans, demographic criteria still may determine whether a plan passes nondiscrimination testing. New comparability won't work for a 27-year-old running a company with six 40-year-olds. It will work for a 40-year-old running a company with six 27-year-olds.

Many business owners will find these disadvantages insignificant when compared with the advantages that new comparability offers.

Figure 3

Accumulations to Retirement

Employee	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	$506,087	$506,093	$506,093	$506,093
Others	235,534	171,809	85,897	47,107
Plan Total	741,621	677,902	591,995	553,205

Figure 4

First-Year Contributions

Employee	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	$29,772	$30,000	$30,000	$30,000
Others	80,652	59,514	51,757	17,254
Plan Total	110,425	89,514	81,757	47,254

Conclusion

As defined benefit plans have become subject to increasing regulation by the IRS, the U.S. Labor Department, and the Pension Benefit Guaranty Corporation (PBGC), new, more attractive defined contribution options have become available. This availability will further hasten both the reduction in the use of traditional defined benefit plans, and the increased use of defined contribution plans, even by small businesses. Efforts by the Clinton Administration to restrict benefits to high-income individuals, including business owners, will make new comparability and other plans that skew benefits in favor of employers, even more attractive.

A word of warning. As this article was being prepared, the PBGC had legislation filed that would disallow cross-testing, which is the basis for designing new comparability plans. The fate of this legislation is unknown, but practitioners should monitor new developments carefully. Even if the legislation eventually is signed into law, Congress could take several years to act on it. Employers

may want to consider adopting a new comparability plan while it is still permitted, then amending to the next most favorable type of plan if and when Congress takes action. J
(I/R Code No. 5900.00/6400.08)

Edward F. Londergan is a consultant of tax-qualified plans for Allmerica Financial. A 1980 graduate of Holy Cross College, Mr. Londergan joined Allmerica Financial in 1983 as an agent for the company's Worcester insurance agency. He joined Allmerica Financial's home office in 1985 as administrator, employer retirement plans, and was promoted to consultant in 1988.

Paul Vickers, ChFC, FLMI, is a consultant of tax-qualified plans for Allmerica Financial. A 1968 graduate of Princeton University, Mr. Vickers earned a master's degree in mathematics from the University of Pennsylvania in 1970. He joined Allmerica Financial in 1974, and has served since then in the systems development division and individual retirement planning area. He received the Fellow, Life Management Institute designation in 1981 and recently earned the designation of Chartered Financial Consultant (ChFC).

(1) Rev. Rul. 81-202. 1981-2 CB 93.
(2) IRC §1.401(a)(4) - 8(b)(2).

JUNE 1993

SKEWED RETIREMENT PLANS HELP OWNERS AT WORKERS' EXPENSE

The new comparability plans take a me-first approach to retirement.

By Donald Jay Korn

For the past several years, traditional defined benefit plans have been on the wane. A survey by the accounting firm Grant Thornton found that 22% of small and mid-sized companies have terminated such plans. "Employers who offer defined benefit plans are subject to numerous administrative requirements and increasing regulations imposed by the IRS, the Labor Dept., and the Pension Benefit Guarantee Corp.," says Andrew Zuckerman, Grant Thornton's director of employee benefits.

For closely held businesses, the bottom line is often increasing expense, for overhead and employee contributions, while contributions to owners' personal accounts are limited. President Clinton's tax proposal, if adopted, would further restrict benefits to high-income executives, including the owners of small companies. "Many employers will see their personal retirement benefits reduced and will be less willing to provide plans for their employees," Zuckerman says.

Ironically, while a substantial amount of squeeze-the-rich activity has been coming out of Washington, the IRS has just proposed regulations under Code Section 401(a)(4) that would permit skewing of benefits in retirement plans. In certain circumstances, so-called "new comparability" plans allow close to 90% of corporate contributions to be made of behalf of owner-executives. "Business owners ask us if these plans are for real," says David McKeon, second vice president in charge of retirement plan marketing at The New England "We're seeing the return of the defined benefit client who's been largely absent since 1987."

These new comparability rules apply to all types of plans but the greatest impact likely will be on profit-sharing plans, which are gaining popularity because of their flexibility. In a bad year, companies can reduce or even eliminate contributions to profit-sharing plans. (By contrast, defined benefit plans lock employers into contributions, come what may.) Judging by the proposed regulations and statements by IRS officials, financial planners can advise their business owner clients to look into new comparability profit-sharing plans.

A basic profit-sharing plan offers simplicity as well as flexibility. A plan might, for example, call for contributions equal to 15% of each participating employee's compensation. An employee earning $100,000 would get a $15,000 contribution, one earning $20,000 would get a $3,000 contribution, and so on.

Such plans may be flexible and simple, but they often don't meet the desires of business owners. McKeon gives the example of a company with two owner-executives, each earning $150,000, and eight other employees, earning a total of $300,000 *(see chart above)*. "The contributions on behalf of the owners would be only half the company's total contribution," McKeon says.

Such problems can be addressed with age-weighted profit-sharing plans, which won IRS approval a couple of years ago and have been gaining ground ever since. In these plans, it's not the annual contribution that has to be equivalent, from one employee to the next; instead, the expected future benefit for each employee must be equivalent, as a percentage of compensation.

Suppose two employees, age 50 and 30, both earn $30,000. In a vanilla profit-sharing plan, each might get a 15% ($4,500) contribution. But that $4,500 will provide a much greater benefit to the 30-year-old employee, when he retires at age 65, than it will to the 50-year-old, when he retires at 65. That's because the 30-year-old

will enjoy 20 more years of tax-deferred buildup.

An age-weighted profit-sharing plan takes those differences into account. The older the employee, the greater the current contribution, because there are fewer years left to retirement. More of a nest egg must be accumulated in a shorter time period. Such plans may be favored by closely held businesses because the owners tend to be older than most of their employees. In the example given by McKeon, the owners' share of the contributions rises from 50% of the total to 68%.

But age-weighted profit-sharing plans have their drawbacks, too. If there are two principal owners, the older one gets a larger share of the pie than the younger one. As you can see in Table 1, the older owner gets a $30,000 contribution (maximum for profit-sharing plans) while the younger owner gets only $22,500.

Also, age-weighted plans may give surprisingly large contributions to other older employees. In this example, a 60-year-old clerk earning $25,000 a year gets a $6,250 contribution. Many business owners don't like the idea of directing such a large contribution to a non-essential employee.

New comparability plans address such concerns. Again, these are age-weighted plans. Plan participants are

"For a lot of owners, their real retirement plan is their business."

divided into groups. Within each group, contributions are the same percentage of compensation. However, the percentage for the older group (presumably the owners) can be much larger than the percentage for the younger group. These plans are designed so the aggregate projected benefits are equivalent, from one group to the next.

In McKeon's illustration, the two owners each get contributions of $30,000, 20% of compensation. Each of the other eight employees, in a group where the average age is 37, gets only 3% of salary. The 60-year-old clerk gets a $750 contribution, not $6,250.

Compared with a plain vanilla profit-sharing plan, total contributions are reduced by more than $20,000, from $90,000 to less than $70,000, while the owners each get a $30,000 contribution, not $22,500. Altogether, 87% of the contributions now go to the two owners. "As long as the average age of the owners is at least five years greater than the average age of the other employees, new comparability plans probably will do the most for owners," McKeon says. "That's been the case in every illustration we've looked at so far."

Will the IRS really approve a profit-sharing plan in which the business owners get 20% contributions and the other employees only 3%? Yes, if certain tests for non-discrimination show that the projected benefits for the rank-and-file are at least 70% of the projected benefits for the highly paid. However, these tests are complex so the services of an actuary or a pension consultant will be needed each year, to insure compliance. "A small company might spend a couple of thousand dollars each year, to implement such a plan," says McKeon. "As you can tell by the example, that may be modest compared with the potential benefits."

McKeon points to other advantages of these plans. "They're extremely flexible," he says. "You can re-set the groups each year, if you wish. Instead of two groups, you might have three groups—owners, key executives, and other employees—giving something extra to key people. Although the IRS hasn't stated this, we think a group can contain just one person. We compare new comparability plans to non-qualified plans, because owners can select employees to get the most benefits, yet contributions are tax-deductible because they're qualified plans."

"There's no question that new comparability plans can deliver more to business owners than a standard profit-sharing plan," Zuckerman says, "and they may well deliver more than an age-weighted plan. Nevertheless, they may not be right for every company."

New comparability plans, like all profit-sharing plans, have a $30,000 annual cap on contributions. Some business owners—older ones with much younger employees—may make considerably larger contributions to their own accounts with defined benefit plans, in the right circumstances. If clients are going to have to pay for an actuary each year, to handle retirement plan calculations, and they're confident the business will generate ample cash flow, they might be better off with a defined benefit plan.

On the other hand, skewing a retirement plan might hurt employee morale and reduce performance. "For a lot of owners," Zuckerman says, "their real retirement plan is their business. Either they'll sell the company or live on dividends. Why jeopardize the success of this business by antagonizing employees? In the end, each business owner has to come up with the choice he or she prefers."

Similarly, financial planners can only advise their business owner clients, not make the ultimate decisions. In order to give the best advice, planners need to know all the options. They need to familiarize themselves with comparability plans, the latest star in the retirement planning firmament, because they may shine brightest on the business owner client who's truly out for himself and isn't concerned with employee retention. FP

THE WALL STREET JOURNAL MONDAY, AUGUST 16

Small Firms Turn Retirement Plans Into Owners' Gain

YOUR MONEY MATTERS

By ELLEN E. SCHULTZ
Staff Reporter of THE WALL STREET JOURNAL

Is it a retirement plan, or a tax shelter?

At a growing number of small companies, it can be hard to tell the difference.

More and more small business owners — including doctors, dentists, accountants and lawyers — are discovering lush loopholes that let them turn retirement plans intended for all employees into tax shelters that benefit mostly the owner or a handful of highly paid people at the top.

The new devices, called "age-weighted" and "cross-tested" plans, enable owners to keep as much as 95% of the annual contributions to the plan, to exclude lower-paid employees, and to reduce the total annual contributions they make to the plan on behalf of rank-and-file workers.

Employers can do this by blending rules used in retirement savings plans with rules used in pension plans. When the resulting formula is combined with regulations meant to prevent retirement plans from discriminating in favor of the highly paid, the result is a legal way to discriminate in favor of the top-paid. How much an owner can actually keep depends on how much goes into the plan, the number of employees, their age and salaries.

"They're tax-planning devices," is how David Wray, president of the Profit Sharing Council of America in Chicago, characterizes them. "Basically, they're put in because one person want to defer as much salary as possible," he adds.

Further, the new tax law will cause these plans to spread like brush fire, pension experts predict. "Before the tax law changed, it was a good deal. Now it's a better deal" for owners, says Marcy Supovitz, vice president of retirement plans for Pioneer Mutual Funds in Boston.

The plans make it possible for employers to escape restrictions in the new tax law on contributions to top-paid employees. The new law effectively limits the annual contribution an employer can make for a person in a traditional profit-sharing plan or SEP (simplified employee plan) to no more than $22,500 — 15% of the total "eligible" compensation of $150,000. But with these new types of plans, the amount that can be distributed to an individual remains 25% of pay, up to $30,000.

Already, these new mutant species of retirement plans are growing like kudzu vines, and strangling milder, existing competitors, such as traditional profit-sharing plans, 401(k) plans and SEPs. Over the past two years, thousands of employers have converted their retirement plans to age-weighted and cross-tested profit-sharing plans.

Keeping a Bigger Piece of the Pie

Business owners can replace existing retirement plans with ones that provide them with a greater percentage of the money contributed. As this illustration for a five-person plan shows, the owner gets 52% of the total contributions to a traditional profit sharing plan in which all employees received 15% of their pay. But under "age-weighted" and "comparability" plans, the owner can keep as much as 85%. Comparability plans also let the owner lower the amount contributed for rank-and-file workers, in this example, saving $8,026.

EMPLOYEES		CONTRIBUTIONS TO PROFIT-SHARING PLANS		
AGE	INCOME	TRADITIONAL (15% OF PAY)	AGE-WEIGHTED	CROSS-TESTED
55	$235,840	$22,500	$28,784	$30,000
55	50,000	7,500	9,595	1,955
45	40,000	6,000	3,395	1,564
35	30,000	4,000	1,126	1,173
25	20,000	3,000	600	782
TOTAL CONTRIBUTIONS		$43,000*	$43,000*	$35,474

*The total amount that can be contributed to plan, by law; this is 15% of the total eligible compensation pool of $290,000. (Under the new tax law, only $150,000 of an employee's pay can be used when calculating contributions to a plan.)

Source: National Life of Vermont

The plans have been given their biggest push by life insurance companies, which administer them for a fee, and sell investments to the plans they oversee. At National Life of Vermont, age-weighted plans comprise 25% of all profit-sharing plans they administer; at Berkshire Life Insurance Co., age-weighted plans account for most of its new retirement plan business.

Some mutual fund companies that have retirement-plan divisions are also moving quickly into this market, including Oppenheimer & Co., Dreyfus Service Corp. and Pioneer Mutual Funds.

There's a lot of room for growth: According to the Department of Labor, 88% of businesses in the U.S. today employ 20 or fewer employees, and those businesses are typically owned by people who are older and better paid than their employees.

Critics say that the new plans pervert the social policy goals of retirement plans, which are given tax breaks because they are intended to help lower- and middle-income Americans put money aside for retirement.

Further, some people note that the plans give employers an incentive to discriminate against older workers. "It makes hiring an older person more expensive," says Harry Conaway, a principal at the Washington office of William M. Mercer Inc., a benefits-consulting concern.

But many pension experts say the new plans fill a need for employers. "These are people who have poured their profits back in their businesses, and don't have that many years until retirement," says Ms. Supovitz. "Younger employees would rather have more take-home pay, rather than retirement savings."

Age-weighted plans were made possible by an Internal Revenue Service ruling, 401(a)4, that went into effect two years ago.

Essentially, it said that retirement sav ings plans offered by employers could us formulas similar to those pension plans us when determining how much money t allocate for employees. Pension formula give older workers the lion's share of th contributions an employer makes to plan. The reasoning is that they hav fewer years until retirement, so a dolla given to them is worth less than a dolla given to a younger person.

About a year ago, the pension con munity realized it could also use cross-tes ing rules to provide even more advanta to top-paid employees. Cross-testing fo mulas were designed to prevent retireme plans from discriminating in favor of t older, higher-paid workers. The rules ba cally require the administrator to div employees into highly paid and lower-pa groups, and make sure that the high paid group doesn't get a significan higher percentage

When these provisions are combin

THE WALL STREET JOURNAL MONDAY, AUGUST 16, 1993

Smaller Firms' Retirement Plans Are Turned Into Owners' Bonanza

Continued From Page C1

with age-weighting formulas, the owner can keep most of the money. "From a theoretical perspective, the plans are non-discriminatory," says Mr. Conaway. "If you convert the dollar amount [that lower-paid people get] to age-65 dollars, the benefit is the same percentage of pay."

But as helpful as the new plans may be for small-business owners, they have serious drawbacks for rank-and-file workers. To begin with, the plans can exclude altogether some lower-paid employees, as long as 70% of the lower-paid employees are eligible to participate in the plan.

Even those who participate may never see a dime of retirement money, however, because these plans have vesting schedules lasting as long as six years. Since younger, lower-paid employees typically have high turnover, many aren't likely to qualify to receive their profit-sharing money. Forfeited contribution are reallocated to the remaining people in the plans, on an annual basis.

"The bottom line is, a large portion of those contributions never go to those employees at all, because of the forfeitures," say Ms. Supovitz.

STATEMENT OF HON. MARTIN SLATE, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Chairman ROSTENKOWSKI. Mr. Slate.

Mr. SLATE. Thank you. Secretary Reich and Assistant Secretary Samuels have underlined the seriousness of the underfunding problem, the need to address it squarely and speedily, and the goals of our reforms. This is indeed the time to move forward to protect pension benefits.

I would like to briefly review our reforms and describe how and why they will work. Our major reforms will strengthen the funding rules for underfunded plans, enhance PBGC compliance authority, increase premiums for those plans that pose the greatest risk, and broaden participant disclosure requirements.

Fully funded plans, most plans, will not be affected by our major reforms. Our primary reform is to strengthen the funding requirements for underfunded plans.

In 1974 ERISA established the concept that money must be put aside currently for benefit payments that are due in the future. The ERISA funding rules meant a good start for sound funding. Acute underfunding persists in part because companies were permitted to fund a portion of their benefit liabilities over a period of 30 or more years.

Thirteen years later Congress addressed these problems again. OBRA 1987 introduced an additional contribution requirement intended to accelerate funding in underfunded plans.

Still, plan funding has not improved since 1987. Companies can use credits and offsets and set actuarial assumptions so that contributions are minimized. Fully within the law, many employers have been able to make little or no pension contributions, even though their plans may be severely underfunded.

Between 1989 and 1992, for example, contributions to half of the underfunded plans of the companies with the largest underfunding did not even cover the interest on their underfunding. As the Secretary has said, this is like paying off only part of the interest on a credit card and none of the principal.

To get funding back on track, our proposals make three changes. First, we would accelerate the funding formula so that in underfunded plans, most new liabilities would be paid for within 5 to 7 years. Second, we end the double counting of credits that has enabled employers to minimize contributions. Third, our reforms require the use of specified interest rate and mortality assumptions to determine contribution amounts so that employers cannot reduce plan funding by setting unrealistic actuarial assumptions.

In addition, our reforms include a special solvency rule to insure that severely underfunded plans meet their benefit obligations. A plan would be required to maintain cash equal to approximately 3 years' worth of benefit payments.

Our proposals will be effective for plan years beginning in 1995. Our new schedules will pick up increases that were negotiated in 1992 and 1993.

Accelerated funding is essential if plans are to be placed on a sound footing. We do want companies to move forward with their business. The legislation contains a special transition rule to pro-

tect employers from extraordinary increases in their annual contributions for up to 7 years.

Our legislation also removes certain impediments that discourage employers from fully funding plans.

Strengthened funding rules should assure improvements in most cases. There are, however, special circumstances where PBGC needs better tools to protect pensions.

All too often, we have seen companies undertaking business transactions that endanger pension promises. For instance, a healthy corporation might spin off a subsidiary in poor health with an underfunded plan. This can leave the subsidiary's plan without a source of funding because the corporate tie is broken. The only remedy that the PBGC has in these circumstances is to terminate the pension plan. This can be a harsh remedy because participants are hurt and the resulting claim for plan underfunding can have serious consequences for employers.

Our proposals would allow PBGC to apply to Federal court for remedies other than plan termination. For example, PBGC could seek to impose funding responsibility for a certain period of time on a corporation that sells a subsidiary. Our reforms are tailored. They would apply only when the transaction is of a substantial nature and only when a transaction poses a risk to the pension system. Our desire is to protect benefits, not to hobble corporate transactions. We also propose to require companies whose plans are underfunded by more than $50 million to provide PBGC with advance notice of transactions that might affect underfunding.

Next, we propose to increase premiums for plans that pose the greatest risk by phasing out the cap on PBGC's variable rate premium over 3 years.

PBGC's annual insurance premium for single employer plans has two elements, a flat $19 per participant that is paid by all plans, and a variable rate charge for underfunded plans. The variable rate charge is capped at $53 per participant.

While plans at the cap account for 80 percent of all the underfunding in the plans, their premiums represent only about 25 percent of PBGC's total premium revenue. We need to put the responsibility where it belongs and change the incentives in the premium structure.

Finally, our reforms would require that timely, clear information on plan funding and Federal guarantees be provided to participants in underfunded plans.

These reforms will markedly increase funding in the most underfunded plans. They are targeted in very specific ways to correct current law and to make it work. We think we have the fix for the problem, and we think it is the right fix. The pension system is fundamentally sound, but the problems that are developing today can become the red flags of tomorrow. It is important to address these problems now while they are still manageable. We must stay ahead of the curve and take every possible step to assure that the hard-earned benefits of our Nation's workers are protected.

Thank you, and I would be delighted to join in addressing any issues that you may have, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Slate.

[The prepared statement follows:]

Testimony of Martin Slate
Executive Director
Pension Benefit Guaranty Corporation
Before the
Committee on Ways and Means
United States House of Representatives

April 19, 1994

I am honored to join Secretary Reich and Mr. Samuels to discuss the Administration's Retirement Protection Act. This is comprehensive, balanced legislation. It will squarely address underfunding in our nation's pension plans and protect the benefits of American workers and retirees.

I. INTRODUCTION

Our reforms may be summed up in one word: funding. We believe that the present pace and certainty of pension plan funding are inadequate and that steps should be taken to assure that sponsors of underfunded plans significantly accelerate their pension contributions.

Our major reform measures will:

- Strengthen the funding rules for underfunded plans;
- Enhance PBGC compliance authority;
- Increase premiums for those plans that pose the greatest risk; and
- Broaden participant disclosure requirements.

Fully funded plans will not be affected by our major reforms.

I join Secretary Reich in expressing appreciation for the leadership that you, Chairman Rostenkowski, your committee and Representative Pickle and his oversight subcommittee have brought to benefit protection. I too share the view that this is the time for reform.

I thought I could be of most help to the Committee this morning if I detailed the growing long-term problem in pension underfunding and then provided further explanation of our reforms . . . how they work and why they will work.

II. THE PROBLEM

Most pension plans are fully funded. Pension underfunding in certain industries, however, is a chronic problem, growing and persistent. In the last six years, underfunding has nearly doubled – from $27 billion in 1987, to $38 billion in 1991, and to $53 billion in 1992. While some of the most recent underfunding is attributable to the drop in interest rates, it is clear that the current funding rules are not working. Certain companies simply are not putting enough money into their pension plans.

About three-quarters of this underfunding is in plans sponsored by financially healthy firms and does not present an immediate risk to

participants or the PBGC. The most severe risk lies with the remaining plans, with an estimated $14 billion in underfunding, accounting for approximately 1.2 million workers and retirees. These plans are maintained by companies with below investment grade bond ratings.

Given the current funding rules, underfunding in these troubled plans is likely to increase in the coming years. For participants, this underfunding threatens the loss of benefits not covered by the PBGC guarantee.

These underfunded plans also pose a risk to the PBGC. The PBGC is in no immediate danger. This is because we pay benefits out over time, just as pension plans do. However, until chronic underfunding is addressed, the long-term health of the PBGC remains in jeopardy. Last week, we announced that our deficit is now approaching $2.9 billion; our deficit has nearly doubled since 1987. The trend in underfunding and in the PBGC deficit must be reversed.

III. APPROACH TO REFORM

The Retirement Protection Act was carefully drafted to reduce underfunding markedly, but in a reasonable, doable way. In preparing this legislation, we set a number of guideposts.

First, we set a goal of funding all vested benefits in 15 years. This will assure that benefits for workers in the industries most affected by underfunding will be paid.

Second, we sought to fix only what is broken. Our reform proposals target underfunded plans. Fully funded plans – most plans – are not affected by our major reforms.

For those who are affected, we sought to make the reforms affordable. Our reforms are based on actual experience under current law and modelling of data from real plans. These reforms will protect the pension benefits of American workers and retirees, while at the same time allowing business to continue. This is especially important. The underfunding gap must be closed, but business and work must move forward. We think the porridge is just about right. The reforms are reasonable.

Finally, we sought to build on current law. We were able to identify the structural problems in the law and to address those problems in a way that will assure that the promise of ERISA is kept for all.

IV. THE LEGISLATION

STRENGTHEN THE FUNDING RULES FOR UNDERFUNDED PLANS

Our primary reform is to strengthen the funding requirements for underfunded plans.

ERISA Rules

In 1974, ERISA established the concept that a plan must be funded in advance - money must be put aside currently for benefit payments that are due in the future. The ERISA funding rules provided a good start for sound funding, but many plans remain severely underfunded. In part, acute underfunding persists because companies were permitted to fund a portion of their benefit liabilities over a period of 30 to 40 years.

OBRA '87

Thirteen years after ERISA, Congress addressed these problems again. OBRA '87 introduced the deficit reduction contribution (DRC), an additional minimum contribution requirement intended to accelerate funding in underfunded plans.

Despite the DRC, plan funding has not improved since 1987. Companies can utilize credits and offsets and set actuarial assumptions so that contributions are minimized. Fully within the law, many employers have been able to make little or no pension contributions, even though their plans are severely underfunded.

Between 1989 and 1992, for example, contributions (after paying for current year accruals) to half of the underfunded plans of companies with the largest underfunding did not even cover the interest on their unfunded liabilities. This is comparable to paying off only part of the interest on a credit card and none of the principal.

Reform Proposals

To get the DRC back on track, our reforms make three changes.

(1) Strengthen the DRC Formula.

First, to speed up funding, we would accelerate the DRC formula so that in severely underfunded plans, most new liabilities would be paid for within five to seven years.

(2) End Double Counting.

Second, we end the double counting of gains (and changes in liabilities due to changes in actuarial assumptions) under the DRC and the plan's funding standard account. This double counting of credits has enabled employers to minimize contributions. A plan sponsor would be required to pay the larger of the DRC or the regular minimum funding requirement.

(3) Constrain Assumptions.

Finally, our reforms require the use of specified interest rate and mortality assumptions to determine contributions. We propose to narrow the DRC corridor for interest rate assumptions to between 90% and 100%

of the four-year weighted average of Treasury bonds and require use of the GAM '83 mortality table. This is the mortality table used by most states to calculate insurance company reserves for annuities. These assumptions are designed to measure the amount necessary to fully fund the plan on a termination basis.

To moderate the impact of this change, plans could amortize any resulting increase in pre-1995 liability over 12 years.

Plan Solvency

In addition to these overall changes in the funding rules, our reforms include a special solvency rule to insure that severely underfunded plans would be able to meet their benefit obligations. To assure benefits are paid, a severely underfunded plan would be required to maintain cash and marketable securities equal to approximately three years' worth of benefit payments.

Benefit Increases

The bill requires that benefit increases be funded on an accelerated schedule - in most cases, over five to seven years. It also requires that employers recognize immediately, for funding purposes, any benefit increases that have been bargained but are not yet in effect. (Under current law, an employer is not required to start funding these benefit increases until they are effective.)

It is our view that benefit increases should be paid for speedily through strengthened funding requirements. Explicit restrictions on benefit increases are not necessary and are unfair to working people and to retirees.

Effective Dates

Our proposals will be effective for plan years beginning in 1995. These new rules will pick up increases that were negotiated in 1992 and 1993.

Transition Rule

Accelerated funding is essential if plans are to be placed on a sound footing. We do, however, want companies to move forward with their business. The legislation contains a special transition rule to protect employers from extraordinary increases in their annual contributions for up to seven years. Although the rule varies according to the plan's funding ratio, it generally limits the required annual increase in employer contributions to the amount necessary to achieve a three percentage point per year increase in the plan's funding ratio.

Remove Impediments to Funding

Most of our funding reforms strengthen the minimum funding requirements. We also want to remove certain impediments that discourage employers from fully funding their plans. For example, we propose to eliminate the excise tax that inhibits companies with both a defined benefit and a 401(k) plan from contributing when the combined funding would exceed 25% of compensation. We also propose to eliminate the quarterly contribution requirement for well-funded plans. Most of our rules would not affect plans with 100 or fewer workers.

ENHANCE PBGC COMPLIANCE AUTHORITY

Strengthened funding rules should assure improvements in most cases. There are, however, special circumstances where enhanced PBGC compliance authority is also needed to provide better pension protection.

All too often we have seen companies undertaking business transactions that endanger pension promises. For instance, a healthy corporation might spin off a subsidiary in poor health with an underfunded pension plan. This can leave the subsidiary's plan without a source of funding because the corporate tie is broken.

The only remedy PBGC has in these circumstances is to terminate the plan. This can be a harsh remedy because participants are hurt, and the resulting claim for plan underfunding can have serious consequences for employers.

Our proposals would allow PBGC to apply to the federal court for remedies other than plan termination. For example, PBGC could seek to impose funding responsibility, for a certain period of time, on a corporation that sells a subsidiary.

Our reforms are tailored. They would apply only when the transaction is of a substantial nature, involving more than 10% of a controlled group's assets, revenues, or operating income and only when a transaction poses a risk to the PBGC. Our desire is to protect benefits, not to hobble corporate transactions.

We also propose to require companies whose plans are underfunded by more than $50 million to provide PBGC with advance notice of transactions that might affect underfunding. Much of this is like the Hart-Scott-Rodino notice procedure used by the Federal Trade Commission in the antitrust area, but it will affect far fewer transactions.

Our proposal seeks several other compliance reforms that will enable PBGC to make a difference in those important situations where the funding rules do not provide sufficient benefit protection. Among these is a requirement that severely underfunded plans annually provide the PBGC with current funding and financial information. The Oversight Subcommittee has long been concerned about the Government's authority to have accurate, updated information about plan funding.

BANKRUPTCY

We continue to support bankruptcy reforms that would: 1) make it clear that companies are required to make their minimum funding contributions before they come out of bankruptcy; and 2) give the PBGC the option of being a member of creditors' committees.

INCREASE PREMIUMS FOR THOSE PLANS THAT POSE THE GREATEST RISK

We propose to increase premiums for plans that pose the greatest risk by phasing out the current cap on PBGC's variable rate premium over three years.

PBGC's annual insurance premium for single-employer plans has two elements -- a flat-rate of $19 per participant paid by all plans, and a variable rate charge for underfunded plans. The variable rate charge is capped at $53 per participant. This weakens the funding incentive for the most seriously underfunded plans.

While plans at the cap account for 80% of all the underfunding in single-employer plans, their premiums represent only about 25% of PBGC's total premium revenue. We need to put the burden where it belongs and change the incentives in the premium structure.

BROADEN PARTICIPANT DISCLOSURE REQUIREMENTS

Our reforms would require that timely, clear information on plan funding and PBGC guarantees be provided to participants in underfunded plans. The more people know about their pensions, the better.

Also, our bill seeks to facilitate payment of benefits to so-called "missing participants." The PBGC has an active program for locating missing participants in terminated underfunded plans that we trustee. Our legislation would build on this effort by establishing the PBGC as a central clearinghouse for employers with terminated fully funded plans who have had difficulty providing benefits to missing participants.

OTHER CHANGES

We propose a number of other changes. These include:

- elimination of "cross-testing" of profit-sharing plans;
- more flexible remedies for the PBGC to address noncompliance in standard termination procedures;
- revision of the interest rate and mortality assumptions that a plan may use to calculate a lump-sum distribution; and
- the rounding down of the annual increases in the contribution and benefit limitations for retirement plans.

V. CONCLUSION

These reforms will markedly increase funding in the most underfunded plans. Again, all vested benefits will be funded within fifteen years. We project, based on prior PBGC experience, that the PBGC deficit will be eliminated within ten years.

The reforms are targeted in very specific ways to correct current law and make it work. At the same time, the reforms are comprehensive and balanced. We think we have the fix for the problem, and we think it's the right fix.

The pension system is fundamentally sound, but the problems that are developing today can become the red flags of tomorrow. It is important to address these problems now, while they are still manageable. If we wait, the medicine will most certainly have to be stronger.

We must stay ahead of the curve and take every step possible to assure that the hard-earned benefits of our nation's workers are protected.

Chairman ROSTENKOWSKI. Thank you all, gentlemen. Secretary Reich, many company representatives argue that this legislation will place a significant financial burden on many of the companies that will be required to accelerate funding of their pension plans.

They further argue that this will cost jobs and could lead to bankruptcy for some of these companies. Could you respond to these arguments, Mr. Secretary?

Secretary REICH. Yes, Mr. Chairman. We have tried to craft this proposal in such a way that it minimizes the burden on underfunded companies. There is a 7-year transition rule, and I want to emphasize this. The 7-year transition rule will moderate any extraordinary increases in funding. Even firms with severely underfunded plans or that are in trouble, because of this built in gradualism can afford these obligations.

You see, the alternative is simply unacceptable. The alternative is that the taxpayers ultimately get caught holding the bag, or worse, with regard to those pensions that are not fully funded, individual retirees get left holding the bag.

We have crafted this to balance the legitimate and important needs of businesses with the legitimate and important needs of retirees, workers, and taxpayers.

Chairman ROSTENKOWSKI. Mr. Secretary, many companies' representatives argue that a combination of the Pension Protection Act of 1987, the reporting requirements of the Financial Accounting Standards Board, and the reporting requirements of the Securities and Exchange Commission negates the need for any further legislative action in this area.

Would you care to comment on that?

Secretary REICH. I simply don't believe that is the case, Mr. Chairman. We do have now a $53 billion underfunding problem. Now, that is twice what we had in 1987.

On top of that, we have many millions of workers who are in firms that may be jeopardized because of this large underfunding problem.

Eight million workers are in underfunded plans. Of these underfunded plans, financially troubled firms account for about 1.2 million workers who have $14 billion in pension underfunding.

It is important that we move forward on a variety of fronts. I am not suggesting that this is a crisis, and I want to emphasize again, we are not now in a crisis, but we are heading in that direction if we don't do something about it. This is reason for concern. Every one of us should be seriously concerned about this problem.

I don't want to be put in the position, and nobody here wants to be put in the position of years from now looking back and saying, Why didn't you correct it when you could have corrected it?

Now that we are coming out of a recession, businesses are seeing their cash flows improve. Even businesses that are severely underfunded and that are maybe the most susceptible to termination, are seeing better times right now. We are coming out of a recession.

If there is ever a time to fully fund, if there is ever a time to adopt this kind of proposal, it is right now. Let's not wait.

Chairman ROSTENKOWSKI. Secretary Samuels, H.R. 3396 contains a provision that would limit the annual amount participants

could contribute to defined-contribution plans and the amount of the annual benefits payable under defined-benefit plans.

Many plan participants argue that this provision should not be included in this legislation because it would hurt a group of individuals that do not contribute to the problem of underfunded liabilities of the PBGC.

Could you respond to this argument and share with us the rationale for including this provision in the legislation?

Mr. SAMUELS. Mr. Chairman, this provision was included in the legislation in order to make the administration and communication with participants easier, and we weigh that against the fact that these so-called rounding rules would affect those participants who were contributing the maximum amount possible.

When we balance those two, we thought that the administrative and simplification benefits of the proposal made it a worthwhile proposal, and in addition, this proposal raises some revenue to offset some of the costs of this plan.

Chairman ROSTENKOWSKI. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman. Gentlemen, I welcome your testimony today because the Congress clearly needs to do something while there is plenty of time to work on this problem.

The one thing the Nation cannot afford is another FSLIC situation, and clearly we are broaching that potentially in the future. Whatever we do, however, it seems to me it must be done very thoughtfully. Perhaps the bad news is out there potentially, but the good news is that the actions of the Congress since 1982, in all of the regulatory activities, in all of the instructions, have brought an end to the development of new defined-benefit plans, so there will be less exposure in the future.

I am not sure that is healthy for the country, but pension actuaries today are telling their clients all over the country, don't bother to put in a new defined-benefit plan because the Federal regulations and restrictions are so massive that it is not going to be beneficial to your company.

Now once again we are told by pension actuaries that your recommendation to repeal the cross testing will be another further nail in the coffin of the defined-benefit plans in this country, particularly for small employers who have now begun to consider the use of that.

I would like first to hear your comment on that sort of comment that we are getting from pension actuaries.

Secretary REICH. Congressman, if I may, we are crafting this plan in such a way that we are going like a laser beam after the problems. We are going after severely underfunded plans.

Now, if we don't do anything about them, the alternative, as I stated before, is for the taxpayer to be caught holding the bag or for a lot of workers and retirees to be left with nothing. And as you said, we have got to do something right now.

There are 41 million participants in defined-benefit plans right now with close to $1 trillion in assets. We are only going after the ones that are underfunded.

You are right that there has been a movement, a trend away from defined-benefit plans to defined-contribution plans, especially 401(k)s. But I will tell you something, part of that drift away may

be due to the fact that a lot of people are afraid. If we don't do something to shore up these plans, to fully fund these plans, to make sure that the worst actors in the most unfunded plans are fully funded, we are going to see a much, much faster drift away.

Workers need protection. Taxpayers need protection. People need information.

Mr. ARCHER. Mr. Secretary, I have some disagreement with you as to why you are not seeing further expansion of defined-benefit plans. We will leave that for another day, but it seems to me that your proposal comes down heavily on the side of how can we make more people pay more into their plans to reduce the risk of the PBGC.

Now, that is not without some merit, but as the Chairman said, we have to be very careful that we do not, in effect, force out of the plans marginal sponsors. You mentioned your transition. Many think it is not adequate.

You mentioned that you would go into court, I believe, as a proposal to see what these companies could afford to pay. What standards will the courts use, and why are you putting something in there as a further burden on an already overburdened Federal judiciary system which cannot handle the cases today and which leaves unprosecuted thousands of violations of Federal criminal law because of inadequacy of court facilities?

Why do you choose that and what standards will the court use to determine what they will order these companies to do?

Secretary REICH. Congressman, let us be very clear about what we are proposing here. We are not proposing any vast raid on the Federal courts. We are not proposing any movement into litigation. We simply want to avoid what is now occurring, when companies with a severely underfunded plan enter into business transactions that endanger their pensions.

For instance, a strong corporate group might sell off an unhealthy subsidiary with an underfunded plan, leaving the plan dependent completely on that unhealthy subsidiary. We have seen that happen.

The PBGC needs tools with which it can go into court and stop that kind of practice. The bill would require sponsors of large underfunded plans to give the Pension Benefit Guaranty Corporation prior notice of transactions that could jeopardize plan funding.

This doesn't mean necessarily going into court. The PBGC could sit down and work with the company, and we expect that there would be a lot of negotiation with the company to make sure that the transaction did not imperil workers, retirees, and ultimately taxpayers.

The PBGC could apply for court remedies other than plan termination when a corporate transaction presents a risk to plan funding and increases PBGC's exposure. Now, again, I want to emphasize this. The reforms are fashioned so as to apply only in cases of severe underfunding. This is not a broad-scale approach. This is simply focusing where the focus needs to be, and the danger is that if we do not focus on these plans, we may find ourselves a few years from now with a huge, huge problem on our hands.

Mr. ARCHER. I understood you mentioned all of that in your testimony, but let me make one last inquiry. The two sides of this,

again, are the question of how much can you force people to pay in, particularly when they are marginal and cannot afford to do it? We have already let that go too far in our guarantee structure. The other side of it is what are you doing to restrict the promises that cannot be realistically funded for the future, which is the outflow demand side?

I don't see very much of that in your plan. It might be, for example, although I personally come down the side of less Federal intervention in determining what people can do in the private sector: As long as we are taking on the responsibility of guaranteeing the solvency of all these plans, as we did in the S&L crisis, then why would it not be appropriate to, whenever a company wants to make an increase in benefits, to have an evaluation of whether it can be appropriately funded. If not, we say if you proceed with this, we will not guarantee you under PBGC and you must notify your employees that if this plan is adopted, there will be no PBGC funding or guarantee.

That would still permit them in the private sector to go forward if they wanted to do it, but it would not obligate the taxpayers and the employees would be fully informed as to the risks that were involved.

Secretary REICH. Well, first of all, let me, again, say that we have tried to balance interests in this legislation.

On the one hand, as you suggested, it is very important to provide transition rules, not to overly burden companies, but to make sure that there is steady progress toward full funding. It is very important to make sure that people get the right information.

On the other hand, we don't want to restrict benefit increases so extensively that it would be unfair to working people and to retirees. Remember, plans for managers generally have benefit increases built in, while blue collar plans must be specifically amended to keep up with inflation or provide other benefit improvements.

We don't want to say, even to an underfunded plan, you simply cannot increase potential retirement benefits. We want to say to them, if you are going to increase retirement benefits for your employees, you must be on a very fast funding schedule.

Mr. ARCHER. Well, Mr. Secretary, you then increase the risk to the taxpayers of this country enormously and I must say that I personally have a problem with that.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, to you and to Mr. Samuels and Mr. Slate, I want to thank you for your testimony. I concur that your bill is balanced, it can be effective, and I don't see any reason why we should hesitate to advance this legislation.

Some of us on this subcommittee think in terms of how we could possibly strengthen it even a little more. But that is yet to be decided. But overall, this is a high benchmark for legislation, and your leadership has been very much appreciated.

Now, you made your recommendations some 6 months ago. Has anything happened within the last 6 months to change your opinion about the need and the effectiveness of the legislation you have proposed?

Secretary REICH. No, not at all. Our evidence is that the problem remains and perhaps, Marty, if you want to speak specifically to the latest data, go ahead.

Mr. SLATE. I would say what has happened has heightened the need for the bill. The underfunding has gone up from $27 billion to $53 billion. Our deficit has climbed to $2.9 billion. The experience of the last 6 months points to the fact that it is all the more important that we move, and that we move now.

Mr. PICKLE. Some contend that maybe we ought to study this and look at it a little bit longer, but when we realize that the unfunded liability increased in 1 year $15 billion—clearly that is the trend and that will continue if we don't do anything about it, and this legislation I think would put a stop to that.

Now, Mr. Secretary, have you had any reaction to reports to this committee about what other committees in the Congress might consider or knew about this legislation? Have you talked to other committees and does the administration encourage them to pass this type of legislation?

Secretary REICH. Yes. I have talked to Education and Labor and the other committees. They are going to move forward. The administration is encouraging other committees to move forward.

We have positive responses from parts of organized labor with regard to this, as well as from some in the business community. This is crafted in such a way that all of the stakeholders feel on balance that this is fair, this is reasonable and that we should move forward with it.

Mr. PICKLE. Mr. Archer raises the point about not allowing companies, through collective bargaining or negotiating agreements, to promise benefits that they don't—they can't finance.

We have a 60 percent funding level required by current law, and some have indicated maybe we might even consider raising that to 90 percent. I think our committee and I hope the whole committee is going to look at this overall to see what is the best approach and whether we should make some other changes to it. But overall, the legislation is needed, and I commend you again.

Now, Mr. Samuels, you have said, and the GAO has previously testified, that the current minimum funding rules have not worked because certain loopholes have been allowed, based on the 1987 legislation primarily.

Are you confident, Mr. Samuels, that if we pass this legislation before us, this committee won't be called back, say 6 years from now, to try to patch up and correct the legislation again? Will this do the job?

Mr. SAMUELS. Mr. Pickle, we believe that this legislation should do the job. We have done our best to identify the existing abuses and to try to contemplate potential abuses.

Obviously I don't think anyone can give ironclad guarantees. We feel we have done the best we can.

Mr. PICKLE. Well, I want to commend you again. I have one last question for Mr. Slate.

Why should we allow each company to make its own mortality assumptions? The bill takes the approach that you ought to use regular insurance standards, the so-called GAM 1983 approach. Should we let each company set their own mortality rates?

Mr. SLATE. No, we should not, Mr. Pickle. Companies have too much flexibility to reduce payments by the use of actuarial assumptions. The flexibility must be limited if we are to fund plans.

To take out the wiggle room, we set an interest rate geared to the interest rate on Treasury bills and GAM 1983 tables as the mortality standard. The rules we designed are intended to make sure that plans have enough money to pay benefits when they terminate.

GAM 1983 is the nationally recognized standard to determine termination liability. It is used by the States. It is used by insurance companies, and it is in the Internal Revenue Code. We need this standard if we are going to get pensions funded.

Mr. PICKLE. I thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman, and thank you for your testimony, gentlemen.

One of the people who is not going to be testifying personally, but submitted a statement for the record, is a gentleman named James Smalhout. He is an economic researcher that began studying during a stay at Brookings Institution and is proposing a book on the subject. He raised the question about the idea of placing a heavier contribution requirement on financially weak sponsors, and he gave a hypothetical.

He said, consider the case of a plan sponsor with a net worth of $20 million and an unfunded pension liability of $100 million. If a new funding standard were adopted that required the company to reduce the unfunded pension liability by $10 million, what would happen?

First, half the company's net worth would be eliminated, putting the firm that much closer to liquidation. Also, the pension fund's portfolio managers might have or would have a clear incentive to adopt high-risk investment strategies in an attempt to help the firm gamble for redemption.

Would you care to comment on that?

Secretary REICH. Yes, Congressman. We have tested these reform proposals using actual experience and real company financial data. Again, the transition rules are very important for companies that are seriously underfunded.

It is inevitably going to be a delicate balance here. On the one hand, you are going to have companies that are severely underfunded. Some of them are not going to be financially very healthy. You don't want to put so high a burden on them, obviously, that you force them perversely to do the wrong things.

But on the other hand, you have got to come down harder than we are now coming down. Right now the incentives are in the wrong direction. Financially troubled firms and healthy firms with severely underfunded liabilities have absolutely no incentive to improve the financial picture.

The question is, how fast and under what circumstances can you get firms to improve their underfunding? How fast can you bring them up to full funding?

If they are financially troubled, how will a transition rule make this affordable? We feel that we have struck the right balance. Again, this is dangerous territory on both sides, but we feel that

it is fundamentally necessary for us to take action. It is fundamentally necessary for Congress to take action, and this reflects the proper balance.

Mr. CRANE. Well, Mr. Secretary, he goes on to say, The most humane way of reigning in the runaway growth of unfunded pension liabilities is not to force marginally liquid companies to put more money into their pension plans, but to reduce them from making retirement promises they can't afford to keep. He goes on to say, "Such a freeze on the guarantee was proposed before the Bush administration went out, but no action has been taken to date in that regard."

Secretary REICH. Again, this goes back to the delicate balance issue. We don't want to put workers in the position, particularly when they are retiring on inflation-rated increases, of not being able to count on certain kinds of benefit increases. Managers are certainly free to get benefit increases. Plans for managers, as I said, generally have benefit increases built in.

We don't want to simply block for workers the possibility of increases in benefits. We just want to make sure when those benefit increases occur, that there is a plan in place to fully fund those benefit increases and bring the entire plan up to full funding.

Now, again, that is a very delicate balance between the interests of all parties, and we feel that we have crafted that.

Mr. CRANE. But the concept of a freeze that he talks about is unacceptable from your perspective?

Secretary REICH. We don't believe a freeze is necessary. We believe that the balanced proposal that we have provided will do the trick. It will bring even severely underfunded plans and financially troubled firms, up to the right level.

Remember, we are also taking the cap off of the premiums so that we are providing the right incentives. Given the premium increase, it may be that a financially troubled firm with a very severe underfunding problem will have less incentive to go deeper and deeper into underfunding.

We just want to make it fair to workers as well as to shareholders, taxpayers and retirees.

Mr. CRANE. But you do concede there is potential for putting both businesses and jobs at risk?

Secretary REICH. In every direction, there is a potential for putting businesses and jobs at risk. Our judgment is that of all the alternatives in terms of the proper balance of burdens, this is the best set of provisions. I also want to underscore our judgment that doing nothing is the worst of all. That is a slippery slope. If we do nothing now, we are going to pay dearly in the future.

Mr. CRANE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Secretary, I have heard from several companies, some in my district, that H.R. 3396 is a response to a distorted view, it is a response that has no basis relative to the solvency of the private employer pension plans, that it really is reactionary and there is no need to respond in this way.

How would you respond to those statements?

Secretary REICH. Well, I would say let's simply look at the data, simply look at the financial condition in which we find these defined-benefit plans. In 1992, we have $53 billion in underfunding.

Now, just in 1987, we were at $27 billion in underfunding. There are now 8 million workers in those underfunded plans. Those underfunded plans sponsored by firms that are in some financial difficulty have 1.2 million workers. We must take action. This is not the time to sit back.

I want to emphasize a theme that we have all emphasized here. If there was ever a good time to do this, it is now—when the economy is recovering, when businesses are recovering, the economy is generally on the right trajectory.

We don't want to try to do this when many businesses are on a downward trajectory, when businesses are going into a slump, when there is a cyclical downturn. You know, Isaac Newton's Law of Economics says that everything that is up eventually comes down.

We want to maintain this recovery as long as we can. I believe we can sustain this recovery, but we don't want to take the chance that if and when there is a next recession, we have a much larger problem on our hands.

Mr. COYNE. Thank you, Mr. Secretary.

Mr. Slate, in March 1993 the General Accounting Office issued a report concerning the protection for retiree insurance annuities. The General Accounting Office made several recommendations at that time. Would you provide for the record your responses to those recommendations and what actions you have taken to implement them.

Mr. SLATE. I will be glad to provide them for the record, but basically what they asked was that we keep a closer eye on the purchase of annuities, and we are doing that. We are working with the Department of Labor very, very closely.

Lawsuits have been filed. I think it is safe to say that all the recommendations that the GAO made were well taken and have been implemented, and we will give you more detail.

Mr. COYNE. OK. Could you make—for the record, make available for the record what you have done over the past year.

Mr. SLATE. Absolutely.

Mr. COYNE. Thank you.

[The following was subsequently received:]

In its March 1993 report, the GAO recommended that PBGC require that plan administrators provide participants, who will be receiving a distribution of their plan benefits in the form of an annuity purchased from a life insurance company, information about the State guarantee coverage that applies at the time of annuity purchase. Because the report also recommended that the Department of Labor take certain actions with regard to annuity purchases by ongoing plans, the Department of Labor and the PBGC created a joint working group to respond to the recommendations. In June 1993, we informed the GAO that the PBGC would proceed with a proposed amendment to its termination regulations to require the disclosure recommended by GAO. We are currently weighing several options to determine the nature of that disclosure.

Chairman ROSTENKOWSKI. Mr. Kopetski.

Mr. KOPETSKI. Mr. Samuels, I was curious about the phaseout period of the premium cap looking at the justification for the—sort of the quick time where you—when you lift the cap on the premium

of, I think, if I understand it right, the cap would be at $53, with the total premium at $72, but under the bill, the cap is removed after 3 years, and I am wondering about the effect of that removal on corporations. Why is it 3 years, and why not phase it out over another 2 or 3 or 4 years.

Mr. SLATE. I think fundamentally, sir, that we have a system where companies who are responsible for 80 percent of the underfunding are paying 25 percent of the premiums.

We need to put the responsibility where it belongs and we need to bring more equity to this system. If people more fully fund their plans, their premiums would be less.

Our sense was to give them a 3-year period to phase it in so that they would have that period of time to get higher on the funding curve, and their premium bite might not be as great as if we did it immediately.

Remember, these are hugely underfunded plans, and they should be paying their fair share.

Mr. KOPETSKI. I don't disagree with that. What I am suggesting is, let's say that an underfunded plan looks at this legislation and says, well, we could pay this back over a 5- or 8-year period, the first 3 years we have got this cap on it. Year 4, boom, we have got to increase the premium payments and so that could have a dampening effect on their business competition ability.

All I am saying is, did you look at—rather than having this light switch approach, saying, well, in year 4 we are going to ask for another $10, in year 5, another $10, and then remove the cap.

Mr. SLATE. As the Secretary has indicated, this is always a delicate balance. Our sense was that by giving companies until 1997 and gradually bringing it up then, it would provide them enough time to get their house in order so the impact wouldn't be that great.

Remember, the premium increases are minuscule as compared to their funding responsibilities. This is an added incentive and we thought that the 3-year period was about right.

Secretary REICH. If I may add something, Congressman. Look at the dimensions of the problem. As you are aware, I am sure, the current premium is $19 per participant, plus the underfunding charge of $9 per $1,000 of unfunded vested benefits.

The underfunding charge is now capped at $53 per participant. Again, this amount of money relative to the scale of some of the underfunding we are talking about is really relatively small. Lifting that cap and allowing the underfunding to be more correlated with the real premiums paid provides a proper incentive in the right direction. We get out of the situation in which, as Mr. Slate said, companies with 80 percent of the underfunding are paying 25 percent of all the premiums.

Mr. KOPETSKI. A second area of questions has to do with the notice requirement on business transactions, 30 days before they would occur. I was curious about the discussions and the workability and practicality of major corporations that are—maybe they are looking at mergers, maybe they are looking at acquisitions of more capital or large expansion and the difficulties involved in negotiations, and then part of all of that is your having to notify the government of this kind of transaction.

Secretary REICH. Well, again, we are only looking at large underfunded plans with regard to those transactions.

Companies with large underfunded plans that engage in major financial transactions will need to notify the government. There is a Hart-Scott-Rodino premerger notification. There are other notifications. We are not tying the hands of companies.

We are not saying at an unusually early stage you have to notify the government of anything. We are simply saying, if you have major underfunding problems, if you are in that category of companies and you are entering into certain kinds of transactions, at least let us know.

At least let us know about it so that we can begin to talk with you about it if we feel that you are going to thereby jeopardize retirement income, or if there is a possibility, an unwarranted probability that the underfunding problems are going to increase.

Mr. KOPETSKI. And a final question has to do with the bill's elective transition rules on these underfunded plans. Well, I think the Chairman would like me to move on, so——

Mr. PICKLE [presiding]. The Chair would yield to you for your last question.

Mr. KOPETSKI. Thank you, Mr. Chairman.

For some plans, the requirement would be 3 percent annual increase per year until 1999 and then 4 percentage points in 2000 and so on.

Did you look at a rolling 3-year average on this? It seems that the rule doesn't allow much flexibility for good investment years and bad investment years.

Mr. SLATE. Well, let me just first of all explain what the rule is. The rule is a transition rule that is designed to cushion the impact of extraordinary increases. It says that you can cap your contributions at 3 percentage points, or as you say, at 4 percentage points in the sixth and seventh year.

So, for instance, if your funding is 60 percent this year and you crank in all the rules and it gets up to 65 percent, we say, OK, you can cap it at 63 percent. Go 63, then the next year, you cap it at 66, and then the next year it is 69, and so forth.

We looked at models of many, many companies to try to come up with this transition figure. We figured that this would even out the contributions. On the one hand, it would get pensions funded, but on the other hand, it would protect employers from extraordinary increases and would moderate the impact where appropriate.

Mr. KOPETSKI. Thank you.

Thank you, Mr. Chairman.

Mr. PICKLE. Now, the Chair recognizes Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman. Mr. Secretary, Mr. Samuels, Mr. Slate, thank you for being here.

What industries will this legislation mainly affect?

Secretary REICH. Congressman, the legislation obviously affects all industries to the extent that there is a particular company in that industry that is severely underfunded. We have found that much of the underfunding is in the automobile industry, in the tire industry, in the steel industry, and some of the mainline basic manufacturing industries in the United States.

That is not exclusively where the problem is, but much of the problem is found in these industries.

Mr. BUNNING. When you were proposing and planning this legislation, did you consult with any of the corporations that might be affected by this legislation?

Secretary REICH. Yes, there was consultation.

Mr. BUNNING. With the auto industry and with the airline, steel, and those industries?

Secretary REICH. Let me turn to the person who was actually the task force chairman for a very specific account, if I may.

Mr. SLATE. Congressman, our task force consulted very, very closely with representatives of business, labor, participant groups, and so forth. Seventy-seven people appeared before our task force and delivered testimony of one sort or another.

Virtually all said that this was a serious problem and recommended substantial legislation.

Mr. BUNNING. Let me ask you this: When Pan American and Eastern and Braniff all went down the tubes, what happened to their pension programs?

Mr. SLATE. What happened was that the pension plans were terminated. People lost benefits and the government was hit with very, very large payments.

I don't have the numbers at my fingertips, but I believe with both Eastern and Pan Am, the PBGC was left with $700 or $800 million to pay in benefits. I also think there were a number of retirees who simply didn't have benefits that were guaranteed and lost benefits.

Secretary REICH. There are 346,000 people relying today directly upon the Pension Benefit Guaranty Corporation for their pensions.

Mr. BUNNING. I noticed this legislation doesn't affect Federal pensions, and you are proposing this legislation because of the large increase in the unfunded liability. Do you have any idea what the unfunded liability is in Federal pensions?

Secretary REICH. I do not. I can certainly get you those numbers. The Department does not have responsibility for Federal plans, nor are we experts in these plans. We know that the issues in the Federal plans are very different.

In fact, the Federal Government has taken significant steps to control its pension liabilities. There is no question in Federal plans about participants not receiving their earned benefits. Obviously there is a serious question about receiving your earned benefits with regard to these private plans.

As you know, Congressman, Congress revamped the Federal system in 1983 to move toward defined-contribution plans so that future costs will be reduced. In my estimate, and again we will get you more accurate information, there is a paper deficit of close to $600 billion, but there is, in fact, enough money to pay benefits for about 75 years.

Mr. BUNNING. You said $600 billion in all Federal? Is that what I understand you to say?

Secretary REICH. There is a paper deficit of close to $600 billion.

Mr. BUNNING. Yes.

Secretary REICH. And there is, in effect, enough money to pay benefits for 75 years. Mr. Panetta considers the deficit to be a long-

range financing issue. We are looking at it in the administration, but it is a different issue from the issue we are dealing with here.

Mr. BUNNING. Last question, the deficit in the Federal pensions as of 1987 when you quoted your numbers for the private pensions comparatively speaking, would that have increased in direct proportion in the Federal pensions also to the $600 billion level that you are quoting me?

Secretary REICH. Between 1987 and 1992, we went from $27 billion to $53 billion underfunding in the private area.

Mr. BUNNING. That is correct.

Secretary REICH. I do not have the data with regard to those same years on the Federal side, but we can certainly get that to you.

Mr. BUNNING. Could you get that to me? I would appreciate that. Thank you very much.

[The following was subsequently received:]

The unfunded actuarial accrued liability for Federal civilian retirement systems grew from a total of $486 billion at the end of fiscal year 1987 to $540 billion at the end of fiscal year 1993, an increase of 11 percent. The unfunded actuarial accrued liability for all major Federal retirement systems, including the military retirement system, grew from a total of $1,032 billion at the end of fiscal year 1987 to $1,054 billion at the end of fiscal year 1993, an increase of 2 percent.

Mr. PICKLE. Now, the Chair recognizes Mr. Kleczka for questioning.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Let me ask two background questions here. We have two figures that we are sharing with the committee. One is the $53 billion figure and one is the $2.9 billion deficit figure.

I think it is important for the committee to understand the difference between these two. I am going to ask Mr. Slate to briefly indicate for the committee what the difference is between the two.

Mr. SLATE. The $53 billion reflects pension plan underfunding. It is the shortfall in pensions if they were to terminate today.

In other words, the assets are one figure, and the benefits owed are $53 billion more than that. OK. The $2.9 billion figure is the Federal deficit. What that means is that given the pension plans that have already terminated, if we were to close down today, that is how much money we would be unable to pay.

We would be able to pay about $8 billion in benefits that are owed in benefits. But we owe $11 billion, so we would have a deficit of almost $3 billion.

Mr. KLECZKA. But on that figure, there has been no taxpayer—no need for a taxpayer infusion of dollars because you are taking the needed dollars off of contributions from the cash flow or dollars coming in, is that——

Mr. SLATE. In the immediate future, in the short run, there is no need because we have the money to pay payments as they become due. Our message is that this deficit is growing and that at some point the rubber is going to hit the road.

Mr. KLECZKA. But if employers who have the option to withdraw from plans who are better funded, if they would withdraw, they give you the underfunded, at that point that deficit would turn real; is that not true?

Mr. SLATE. It would turn more serious.

Mr. KLECZKA. Mr. Bunning's questions indicated, the Eastern Airline example, there was a $700 million taxpayer input. But there really wasn't, Mr. Slate, because the taxpayers weren't asked or the Federal Treasury did not put $700 million in. Again, we borrow from other funds existing in the agency.

Mr. SLATE. And that money came from other employers who were paying premiums, Mr. Kleczka.

Mr. KLECZKA. I want to clarify those two or three points. The question I have of the bill as introduced, which I support and I really have to say that the chairman of the subcommittee deserves our compliments for keeping on this issue, in fact it is my anticipation that we must pass this particular bill or something very close to it because I think if—once Mr. Pickle retires, the impetus to do something might be lost with that, and I would sure hate to see that moment lost, but the bill does only address single employer plans, and there is also a pending problem, although maybe not as serious, with the multiemployer plans.

Now, could you explain to me and the committee why we don't also address in this legislation the multiemployer plans, although the problem is not as great, it could grow to be as great in the future.

Mr. Secretary.

Secretary REICH. Well, Congressman, our analysis with regard to multiemployer plans shows no need for reform right now. Improvement has been marked in multiemployer plans.

Underfunding has gone down from $33 billion in 1980 to approximately $13 billion in 1992. In the multiemployer area, underfunded plans have gone from about 60 percent funded to 80 percent funded.

There have been only a dozen claims against the Pension Benefit Guaranty Corporation, and the PBGC is running a surplus of about $275 million in its multiemployer program. The sweeping reforms that Congress passed in this area in 1980, strengthening the funding rules for multiemployer plans, seem to have worked fairly well. There is not nearly the problem—in fact, it is going in the right direction. In these other areas, we are going in the wrong direction.

Mr. KLECZKA. The last question I have and I relate back to a person who testified before the committee who thought the company he worked for had a decent pension plan. He thought it was fully funded.

Once he retired, I think he was an early retiree, found out that the pension plan was not as solvent or was not solvent at all, and at that point we discussed some plain English notification to employees as to the status of the plan. You address that in the bill.

Could you relate what provisions you put in the bill relating to some notification to employees that the plan is in good shape, bad shape, or something to be watched?

Mr. Slate.

Mr. SLATE. Congressman Kleczka, again, you have been the leader in this area, and I am glad you have called it to our attention. I think we are moving forward here.

Every year, underfunded plans would have to issue a plain English notice to employees informing them of the level of

underfunding in their plans and PBGC guarantees. We will provide model notices for employers. We will monitor to make sure that those notices go out.

The more people know about their pensions, the better, and we are going to make sure they know about their underfunding.

Secretary REICH. I also want to thank you, Congressman, for your leadership in this area. Our view is that many employees, in addition to all the protections, the financial protections we are talking about, just need good information. They are simply not told, they don't understand the situation they are in.

They don't understand the extent to which they may need to take some action themselves to supplement their retirement income.

Mr. KLECZKA. Annuities, retirement benefits, insurance policies. These are things people don't understand, so we have to be a little more forward in letting them know what is transpiring.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you.

Now, Mr. Jefferson, the Chair recognizes the gentleman from New Orleans.

Mr. JEFFERSON. Thank you, Mr. Chairman.

I would also like to thank Mr. Kleczka for his leadership on the questions that he has raised.

I want to talk to you about one particular question that relates to problems of my district, and probably in some other States as well. It has to do with the issue of the legal standing of former participants of a terminated pension plan to bring suit against the plan's sponsor for breach of fiduciary duty. It arises out of the failure of the Executive Life Insurance Company of California issues.

Essentially, it boils down to this: The PBGC now takes the position that it guarantees the benefit when it is provided directly by the pension plan. It is not guaranteed, however, if it is provided through an insurance company. This is the problem, Mr. Secretary, and it is a substantial problem for a large number of people.

It seems that the position that is currently taken is in direct conflict with a written position taken by the PBGC in its 1981 regulations when it declared that such annuitants were covered by the PBGC guarantee.

So I need to know how you feel about having some clarifying language written into this bill to make it clear, and in keeping with what Mr. Kleczka is talking about on another issue, that those former plan participants who receive annual benefits through insurance companies have the same legal rights as those who are current participants in pension plans.

Secretary REICH. We are quite receptive to that clarifying language, and we would like to work with you on that. Let me ask Marty for his view.

Mr. SLATE. Our approach was to shore up the private system as it is now before turning to expansion. The State systems do protect private insurance. The system is expanding. It is improving, and we were rather reluctant to expand Federal exposure in this area rather than to lean more heavily on the States.

We are doing everything we can. We are monitoring fiduciary violations and so forth. For the time being, our position is that we

ought to work on the present system and not expand the guarantee.

Mr. JEFFERSON. A great number of State systems do not provide a guarantee in this area. My State is one of those. There are a number of other ones.

So if you are relying on that, you are relying on really no safety net at all for these people. That is a poor position to leave them in. If we are going to talk about reforming, we need to talk about the whole picture it seems to me.

I wish you would take a closer look at this question.

Secretary REICH. The issue comes down to one of where the underlying guarantee is going to come from and how far the Federal Government absorbs responsibilities that may be traditionally, particularly the insurance area, under the States.

We are very sensitive to the issue. We are sensitive to the problem. In fact, the Pension Welfare Benefits Administration of the Labor Department is struggling with some related issues recently. Where States either drop the ball or where insurance providers or other providers have managed to somehow skirt State law, there is a gap there, and we do have to worry about it.

I am not sure that we have come up with a right answer, given limited resources and given the obvious constraints on Federal liability that need to be maintained, but I do want to stress that we are happy to work with you on this.

Mr. JEFFERSON. I will be in touch with you further on this, Mr. Secretary.

Thank you.

Mr. PICKLE. Now, the Chair recognizes Mr. Houghton, and before recognizing him, I want to say that Mr. Houghton is the ranking member on the minority side on our subcommittee, and he has been extremely active in consideration of this legislation and most cooperative, and I am pleased to recognize Mr. Houghton at this time.

Mr. HOUGHTON. Thank you very much, Mr. Chairman.

I was going to say something nice about you, but it looks like that happened already. But I do appreciate your leadership, Mr. Pickle, on this issue because it clearly is an issue whose time has come.

I don't have any technical questions to ask you. However, what I would like to do is to get a feel for a couple of points, because ultimately this has to go down into the practical world out of this room into something which affects people.

The first question is that in the 1987 law, the trigger point was something like 30 percent unfunded, or maybe 35 percent. Now, you move it up to 60 percent. That makes sense. Why didn't you go to 90? Why didn't you go to 100? Why didn't you go to 70? What was so magic about 60 percent?

Mr. SLATE. Well, we did a lot of analysis, Mr. Houghton, on data, plan funding and financial projections. We thought that that was the crunch point. We should raise it to that point and then start gradually declining.

The whole purpose of our bill is frankly to hit the underfunded plans the hardest, and then to gradualize as we go up that curve. That is where our analysis took us.

Mr. HOUGHTON. Do you ever see the point at which possibly the Federal Government gets out of the guarantee business?

Mr. SLATE. That would be a wonderful day, if the guarantee was no longer needed. The purpose of our bill, Mr. Houghton, is to see that all vested benefits are funded within 15 years.

Mr. HOUGHTON. What you are doing is inching this thing up from 35 percent to 60 percent. It might come at another notch later on.

Mr. SLATE. My hope is that this bill itself frankly will be the answer, and that if this bill is followed, there will be marked increases, and we will not be back to you asking for more help.

Mr. HOUGHTON. OK, final question. You keep talking about $53 billion, this amount has risen quite dramatically in the last 5 or 6 years, maybe doubled, of unfunded liability and the guarantee of the Federal Government.

I also understand from the PBGC that of that $53, there are about $14 billion in companies that are having difficulty. What practical effect is that going to have on those companies and on the economy?

Secretary REICH. We don't believe, Congressman, that imposing these requirements, again, with the transition rules in place would, in any way, imperil even those companies in some financial difficulty. In fact, we designed this in such a way that those companies in financial difficulty would not be imperiled.

Again, we are trying to achieve a careful balance between not being too harsh and not being too lenient. Some people from one side would say we are imposing too many burdens too quickly. Some people on the other side say we are letting companies continue to get away with too much. It is a very careful balance.

We have looked at company experience. We have looked at the data. We have run models. We believe that we have hit the right balance.

Mr. HOUGHTON. Thank you.

Thank you, Mr. Chairman.

Mr. PICKLE. Now, the Chair recognizes Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

I also appreciate the testimony and the need for us to move forward with significant legislation in this area. Secretary Reich, one statement you made I have a hard time following, and that is that the enactment of this legislation could encourage more defined-benefit plans because of the safety issue.

In recent years, my understanding is we have seen very few new plans in this area. Most have been in the defined-contribution area. A new company—a company that starts a defined-benefit plan would not have an underfunding issue, I assume, by definition, and therefore would not fall into any of the high cost, either before or after the enactment of this legislation.

So I don't quite understand that—I mean I think the point raised earlier with Mr. Archer about the complexities is a real detriment to companies starting a defined-contribution plan.

Secretary REICH. Well, there are two other issues here as well though. One is the point that was raised a moment ago, and that is the potential adverse selection. That is, premiums are based in part upon the necessity of keeping the entire system afloat.

If we get in a situation where we have not only severe underfunding, but somewhere down the road we don't take the actions we need to take and the PBGC itself is in deep deficit, those premiums will obviously have to go up for all companies. We will get into an adverse selection process in which companies that are relatively healthy don't continue their defined-benefit plans.

New companies coming into the system don't want to provide defined-benefit plans. So that is problem No. 1. If we make the system healthier, we make it more attractive for companies to stay in and to come into the system.

And issue No. 2 has to do with the reputation of defined-benefit plans. If workers feel that they are somehow in jeopardy, that employers don't have confidence and workers don't have confidence in defined-benefit plans, if companies are using all the legal room they now have to fail to fund them adequately and are using some fancy financial transactions to basically rid themselves of the portions of the companies that are most troubled and where underfunding is most severe, then you are not going to have public confidence. You are not going to have worker confidence in these kinds of plans, and you are going to see ultimately, potentially, a faster shrinkage.

Mr. CARDIN. I appreciate that and I think the point is well taken. I would also suggest that if it is the policy to encourage more defined-benefit plans, that we need to look beyond this specific legislation to make it easier for companies to move in this direction.

Secretary REICH. That is absolutely right, Congressman. I think this legislation is not designed to increase attractiveness of defined-benefit plans per se. This legislation is designed to avoid a problem that is growing every day.

Mr. CARDIN. And I agree with that. Let me emphasize this point. You and I both agree that we need to encourage more pension plans, more protection for retirees, and I would hope that as part of the strategy, we would look into ways of encouraging greater use of defined-benefit plans.

Let me just ask a very basic question. It has to be very disturbing to see the single year increase in the underfunding liabilities. What has caused it? Can we—why are we seeing such a dramatic change in 1 year?

Mr. SLATE. I think that this is a continuing change, and the bottom line is that enough money isn't being put into pension plans. As I indicated, half the plans didn't even put in the interest, never mind the principal.

There is no question that in that year, interest rates went down and in general, liabilities of all sorts, as a result of interest rates, went up. But every calculation that we have done has said underfunding would have gone up substantially anyway.

Interest rates perhaps were the factor that put the extra swell on it last year.

Mr. CARDIN. Are the companies complying with their minimum requirements?

Mr. SLATE. The answer is yes. They are doing the minimum that the law requires. The reason we are here today is simply that, the law does not require enough, and we need to put some certainty and speed in the law.

Mr. CARDIN. And the assumptions on interest were wrong because of the reduced interest returns? Is that——

Mr. SLATE. Among other things, yes.

Secretary REICH. But even without, I want to underscore something that Marty alluded to. Even had there not been declining interest rates, starting in 1987, we would still be seeing the same downward trend.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Cardin, we will keep in mind that I think some 85 to 90 percent of the companies are fully funded. They are up with their payments and they are in full compliance.

The problem has been with just a select group that gets worse and worse and worse.

Mr. CARDIN. I understand these are the——

Mr. PICKLE. Part of it simply goes back to the 1987 law. We are closing the loopholes that the 1987 law permitted and now if we could pass this legislation, I think that will do that.

Mr. CARDIN. The profile of a company you are referring to is a company that has had a plan for a long time, has an older work force or doesn't have the bottom line earnings that it one time had, and it is more difficult a burden to meet these obligations. I assume that is the typical type of company that we are referring to today.

Secretary REICH. Yes.

Mr. SLATE. Yes.

Mr. PICKLE. None of us know the exact reason, but basically these companies have chosen not to fully fund their plans. That is the long and short of it.

Now, the Chair recognizes Mr. Jefferson.

Before we do, let me point out that the House is still in recess until noon. We have some others who want to question. We also have the GAO to be heard from, as well as three other panels, so I would hope that we could move along as quickly as we can.

I now recognize Mr. Reynolds. Mr. Reynolds.

Mr. REYNOLDS. Thank you, Mr. Chairman.

First of all, let me thank the Secretary and the other folks testifying here today. This has been interesting and I appreciate it. I had a quick question to the Secretary.

Mr. Secretary, how are the transition rules arrived at in H.R. 3396? How did the administration arrive at the 7-year transition period?

Secretary REICH. Well, we arrived at the transition period by looking actuarially at what companies, often companies with severe underfunded plans could afford given the new burdens that we would put upon them. We looked at what seemed not only reasonable, but what was affordable.

And again, the guiding principle was that same balance that we have been talking about throughout this testimony—not being overly harsh, not being overly lenient, but making sure that we reverse the trajectory that we are now on toward greater and greater problems of underfunding. In actuarial terms, that seemed about the best place to do it.

Mr. REYNOLDS. Thank you very much, Mr. Chairman.

Mr. PICKLE. Now, the Chair recognizes Mr. Hancock.

Mr. HANCOCK. I want to thank you, Mr. Chairman.

We have been looking into this issue of underfunded pension issues for some time, first on the Oversight Subcommittee, and now here at the full committee level.

I have some real problems in determining and finding out exactly how this unfunded liability is calculated.

For instance, some companies say that the PBGC's calculations in determining this potential, these liabilities, that their calculations are flawed. Things aren't really as bad as they seem. So what I would like to know or try to find out is just how do we determine the potential liability and how accurately can we project this liability?

I hope we can get some really short answers. What were the prevailing interest rates when PBGC calculated the funding liability the last time? Have rates risen or fallen since that time?

Mr. SLATE. 6.4 percent, sir.

Mr. HANCOCK. How often is this recalculation made? For instance, interest rates went up a little bit yesterday.

Do you calculate it every time that there is a change in the long term rate, the government bond rate?

Mr. SLATE. We try to keep an internal finger on it, sir, but the plans report once a year under the law. We take that data, and we apply the prevailing interest rate at that time.

Mr. HANCOCK. Well, under the circumstances, with what has happened in the long-term bond market, is it not possible that this $53 billion has gone down a little bit just in the past say 30 days? How long ago was it calculated?

Mr. SLATE. Anything is possible on a day-to-day basis, but the bottom line is that underfunding is chronic, and it will not go away without legal reform.

Mr. HANCOCK. Well, all right. Is it true that your forecasts are based entirely on long-term government securities, on the interest rate on long-term government securities? Your forecasts are based on that?

Mr. SLATE. Our forecasts are based on annuity purchase rates, which are what it costs to pay people if they terminate a plan. We figure that best measures exposure to participants in the PBGC.

Mr. HANCOCK. In other words, there are a small number of pension plans that actually are invested in long-term securities now, government securities.

Now, you are saying to me that you do calculate the fact that a lot of these are invested in the stock market in the equity market rather than in fixed income securities? That is included in your calculations?

Mr. SLATE. Our calculation measures exposure to participants in the PBGC.

Mr. HANCOCK. Another question then. We say we have 41 million people who are covered under defined-benefit plans. What is the work force? I mean, the jobs in this country. There are around 110, 125 million jobs?

Secretary REICH. Yes, you are talking about a substantial portion of the work force, maybe a third of the work force. With regard to the workers in nondefined benefit, defined-contribution plans, we are moving in almost about even as far as the information I have.

That is, you have just about the same number of workers in both defined-benefit and defined-contribution plans.

Mr. HANCOCK. How many of these defined-benefit plans are government plans like, say, State plans or schoolteachers' programs or——

Mr. SLATE. That figure does not measure public plans. We only insure private plans and there are 41 million people in these private plans that we insure.

Mr. HANCOCK. Have you looked to some of the public plans?

Mr. SLATE. Not as part of this exercise. ERISA does not cover it.

Mr. HANCOCK. No. But you know, when we make those same situations, for instance, my State recently decided they were going to reduce the retirement age from age 60 to age 55 for full benefits.

As far as I know, they didn't do any calculations as far as the increase in funding for that. I guess the taxpayers are going to have to eat that one too.

Secretary REICH. Congressman, the Department of Labor does not regulate State and local plans, but of course, participants in all plans, do need to be concerned about plan funding, and they need to be notified. They need good information.

Mr. HANCOCK. One of the points I was trying to make, and I will frankly admit there are some businesses that might in some particular instances, try to take advantage of their employees, but I do not believe that it is a general problem.

I believe that in general, business in this country is very concerned about the pension plans that they are offering to their employees. We need to recognize that probably 97, 98 percent of the private sector employers are attempting to act responsibly.

In fact, I believe that there are some restrictions, even on the ones that might want to overfund. I mean, just in case of an emergency. You know, we have restrictions on how much they can put in.

In other words, we know that if they put in a little bit more, even though they are conscientiously trying to make sure that it is properly funded, that the government says you can't put that money in there, you are restricted on how much you can even put into those plans.

Mr. SLATE. The answer is that at certain levels, the tax rules do restrict, or impose an excise tax on, overcontributions. I think that the Congress just decided that at some point they want to cut off the overfunding.

Mr. HANCOCK. Isn't it also true that if you want to guarantee these pensions, it wouldn't hurt anything to put in just a little extra once in awhile?

Mr. SLATE. Maybe not. What we have done in our case, sir, as you know, is to eliminate the excise tax in certain situations where people have more than one plan and they want to fund the underfunded defined-benefit plan.

We are trying to take penalties away in such a situation.

Mr. HANCOCK. I just want to make sure that we recognize the private sector as mostly wants to fund these——

Secretary REICH. If I could just speak to that, Mr. Chairman, just for one moment. Undoubtedly the private sector mostly wants to fund its pension plans, mostly is concerned about the welfare of its

workers, mostly is acting responsibly. But in this area, as in so many others, we must be concerned about those who are not fulfilling their responsibilities, thereby jeopardizing their workers and potentially jeopardizing taxpayers.

Mr. HANCOCK. Thank you.

Mr. PICKLE. Before I recognize Mr. Levin, I want to point out, the Secretary advised us earlier, he had to leave around 11:45, but I understand now he will be willing to stay for this last round.

Mr. Levin will be recognized last and that is the last one on the Democratic side. I think we have a couple more left, two or three here.

Can you stay for those three additional, Mr. Secretary?

Secretary REICH. Yes.

Mr. PICKLE. We will go right ahead.

Mr. Levin is recognized.

Mr. LEVIN. Thank you, Mr. Chairman, and congratulations to you for your efforts.

This is sometimes on the surface a dry subject, but it is a vital one, and congratulations to the administration also for helping to grab a hold of it. There has been a suggestion or a plea here for balance, and I think it is very much in order.

We have to be very concerned about the underfunding, also realizing that parts of the private sector have been trying to push out the horizons here so that retired workers, hourly and salaried, have some adequate retirement provisions.

Let me just ask you then, time is short so—and I won't impose on you, Mr. Secretary, so let me just ask one of the several questions I was going to raise, and it relates to balance. The mortality tables, for example. Clearly we have to make sure that the assumptions are realistic, but a question has been raised, should we supersede experiences within companies by use of a standard table that is really utilized mostly by States for other purposes?

Are we going to go too far in terms of standardization here and as a result, have an unnecessary and perhaps unintended impact on particular situations? Do you see any reason for concern there?

Secretary REICH. Congressman, let me make sure I understand your question. Are you saying that should we—firms or different industries may have different demographics and therefore we should——

Mr. LEVIN. Right, right.

Secretary REICH. Basically we are using annuity purchase rates. The annuity purchase rates do take into consideration all of the demographic factors, the mortality tables and so forth.

I don't believe that we can outguess what the annuity market would tell us. I can't see us getting into any more finely grained analysis with regard to mortality tables.

Again, we are only looking at underfunded plans here, remember, but again, we are willing to work with you if you have some suggestions.

Mr. LEVIN. Maybe we should do that, and again, I think the basic thrust here is vital, and it is important that adequate pensions be adequately funded, otherwise they are not adequate pensions, and no one wants companies to pass the buck to the taxpayer or to other companies.

I think we need to be sure as we proceed to get a handle on this that we use procedures that are effective and appropriate, and it may well be that the mortality tables used by States for insurance carriers should be applied here, but I would like to talk to you about it and see. If that is where the evidence lies, so be it.

Secretary REICH. We would be happy to talk to you.

Mr. LEVIN. As I finish, have you chewed over this a lot? Has this been a major issue in your discussions?

Mr. SLATE. Yes, absolutely. We have considered the use of actuarial assumptions, the fact that they have been used to minimize contributions and we have tried to develop controls on them.

Remember, we are trying to get plans funded so that they can pay out benefits. Until they hit that point, it is important to use a uniform standard so that we may close off all possible loopholes.

Mr. LEVIN. Thank you very much.

Mr. PICKLE. Now, the Chair recognizes a member of the subcommittee, and a good one, Mr. Herger.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman. I know we have been here for almost 2 hours and we have several more witnesses, so I just have a very short question.

I would like to direct it to you, Mr. Samuels. In your testimony, you talked about the abuse in our use of cross-tested benefits, and I share your concern on this. I have received, however, some correspondence from several of my constituents in northern California in which they acknowledge there is abuse, but yet would hate to see the system done away with completely. I believe we pretty much do away with it completely the way the legislation is written.

My question to begin with would be, do you believe that the entire program is one big abuse or do you believe there are some instances in it where we could correct the system and not throw it completely out?

Mr. SAMUELS. Mr. Herger, as I mentioned in my testimony, we have consulted with a number of groups and in the course of those consultations, this is exactly the question that we have been asking, and as I also said, we would be prepared to work with this committee.

We think that there may be some plans where we think we should allow them to continue and just really focus on the abusive plans. So I would repeat, we would like to work with you and the rest of the members of the committee in trying to prepare and have evolve an appropriate standard.

Mr. HERGER. Very good. I appreciate that.

I just wanted to confirm that, and I would like to continue working with you. As we go into it we make sure we do away with the abuses but keep the positive parts of it.

So with that, I thank you and, Mr. Chairman, that ends my questioning.

Mr. PICKLE. Fine, thank you.

Now, Mr. Sundquist is recognized.

Mr. SUNDQUIST. I thank you very much, Mr. Chairman. I just have a couple of quick questions.

Mr. Slate, in written testimony from the Pension Issues Coalition, I see that it stated that your projections assume that PBGC

will suffer annual losses about equal to the sum of all the losses the agency has incurred in its 16 years.

Is that a realistic assumption? And if your answer is yes to that, what do you base that on?

Mr. SLATE. I don't have that piece of paper in front of me. What I can simply say is that the agency has suffered losses. Given the current funding flow and given the pace of terminations, we will continue to suffer losses.

Projections are projections, and I don't think it would serve a purpose to quibble over them. What I can be certain of is that our deficit will continue to grow unless we have stronger funding rules.

Mr. SUNDQUIST. Mr. Slate, I appreciate your comments, but you didn't answer my question. We have a right to know the basis for your projections if the projections that you assume are the PBGC will suffer annual losses that would be equal to the sum of the first 16 years.

That is not an unfair question, is it?

Mr. SLATE. Sir, the PBGC has a number of projections. I think what the Pension Issues Coalition is talking about in their document is that one of our projections is simply based on past practice. It says that given the experience of the last whatever it is, 10 or 15 years, that our deficit will go up $2 to $3 billion over the next several years. Projections are projections.

We are not here to try to persuade you of specific projections. What we are here is to show you that there are clear trends and they must be reversed.

Mr. SUNDQUIST. Well, except for the way we reverse those trends is by legislation.

Mr. SLATE. Yes.

Mr. SUNDQUIST. Depending on how serious the problem is, we have different approaches to legislation. So clearly your information is the basis for your criticism, and maybe rightfully so.

I just want to know the extent of it, and if you are unwilling to do it right now, would you submit it to me in writing?

Mr. SLATE. It is in our annual report, and I am quite willing to do it. As I say, our projection is that in the next few years, in normal circumstances, our deficit will go up by $2 or $3 billion.

Mr. SUNDQUIST. Last question. How does the PBGC's rate compare to the average rate of return for a pension plan's assets? I understand that pension plans are required by law to have diversified portfolios and many of the plans listed by PBGC as underfunders actually get returns on their assets in excess of 11 or 12 percent per year.

Mr. SLATE. Some do, some don't. As I say, our purpose is to fund plans so they will be funded if they terminate. Our rates, the funding rates, are geared toward that, and that is not just PBGC rates. It is rates done by insurance companies and all other people who are assigned to make sure that pension plans or other annuities are funded.

Mr. SUNDQUIST. I think all of us want to make sure that they are funded, and we don't want the situation to get worse.

We want it to get better, but I want to make sure that the figures we are basing changes on are realistic figures, and the an-

swers we impose don't just create more problems. So if you could furnish me with those numbers, I would appreciate it.

Mr. SLATE. We will be delighted, and I am sure you will be satisfied.

[The following was subsequently received:]

Your question about the PBGC's projections refers to the written testimony of the Pension Issues Coalition which states: "The conventional wisdom—supported by the most pessimistic projection in PBGC's 1992 Annual Report—appears to be that the PBGC will have a deficit of over $20 billion by the turn of the century. But that projection is highly speculative. It assumes that PBGC will suffer annual losses about equal to the sum of all the losses the agency incurred in the first 16 years of its existence * * *"

The Pension Issues Coalition is incorrect. PBGC has never made a deficit projection that assumes annual losses about equal to the sum of all losses incurred in the agency's first 16 years of existence. During the first 16 years of its existence, PBGC incurred losses of over $5 billion ($4 billion, if probable losses are excluded). The 10-year pessimistic deficit projection in the PBGC's 1992 Annual Report assumed annual losses in the range of $1.2 billion to $1.8 billion.

The 1993 pessimistic forecast shows a $13.8 billion deficit at the end of 10 years and is based on annual net claims of $1.2 billion. The pessimistic forecast reflects the potential for heavy losses from the largest underfunded plans by assuming that all such plans of sponsors with below-investment-grade credit ratings will terminate uniformly over the 10 years. The 1993 Annual Report characterizes the pessimistic projection as highly pessimistic. (A more pessimistic forecast, corresponding to the lower bound of the pessimistic range in the 1992 Annual Report, was not made in 1993.)

PBGC uses its mid-level forecast, which is based on the claims history of the most recent 12 years, for analysis. The 1993 mid-level forecast is based on annual net claims of $695 million and produces a deficit of $5.0 billion at the end of the 10-year forecast period.

Mr. PICKLE. Now Ms. Johnson, we recognize you.

Mrs. JOHNSON. Thank you.

Most of my questions can be answered with a very brief statistic or yes or no in view of the time and further explanation later.

Does your proposal prohibit companies with underfunded pension plans or companies in bankruptcy from increasing pension benefits?

Secretary REICH. It does not prohibit companies with underfunded pension plans from increasing benefits. It does, if they do so, impose a very strict timetable for coming up to full funding. With regard to bankruptcy, I think it does prohibit benefit increases from becoming effective until the company comes out of bankruptcy.

Mrs. JOHNSON. Thank you.

Does it remove all the barriers for accelerating funding for underfunded companies with underfunded plans?

Secretary REICH. I am sorry. Could you repeat the question?

Mrs. JOHNSON. It is the question that Mr. Hancock asked, but I didn't get clear from your answer whether you really remove the barriers to companies contributing more in order to get up to full funding more rapidly.

Mr. SAMUELS. Mrs. Johnson, the proposal removes some of the barriers, not all of the barriers.

Mrs. JOHNSON. Why don't you propose removing all of the barriers? Why don't we want to encourage every company who possibly can to get up to full funding as fast as possible?

Mr. SAMUELS. I think that the question here is a balance of those situations where the company doesn't really have control over the

funding rates, which are the instances that—one of the instances that our proposal deals with, and I think that has to be balanced against companies that, in effect, put in more than is required to use the tax shelter of the tax-exempt fund.

Mrs. JOHNSON. I certainly appreciate the problem of not wanting to subsidize over investment, but I would like in writing some better explanation, or perhaps we can talk about it later.

I think we should encourage in every way we possibly can companies to get fully funded, and I am concerned that through a number of questions and answers I have gotten the idea that we don't do everything we can in that regard.

Of the total amount of underfunded benefits covered by PBGC, what percentage and amount are attributable to the 50 companies on your list, the 50 worst most underfunded companies? What percentage of the whole problem is in those 50 companies?

Mr. SLATE. Well, we can say it is about 38 over 53, so what does that come to, about 65, 70 percent.

Mrs. JOHNSON. I assume that there are no small businesses in that group?

Mr. SLATE. Well, there may be small businesses that are somewhat underfunded, but this is largely a big company problem, Mrs. Johnson. Most of our provisions do not affect plans with 100 or fewer participants.

Mrs. JOHNSON. I heard you say that, but it doesn't jibe with the statement by the American Society of Pension Actuaries who believe that this bill should not be passed unless section 408 and cross testing is deleted because if it is not deleted, it will eliminate plan designs that have spurred growth in retirement plans in small companies, and being primarily concerned with the small company issue and having seen a disastrous, almost catastrophic decline of pension funds in small businesses, I am concerned that you would eliminate a plan design that deals with cross testing in a way that small businesses can survive.

So I am concerned by the testimony of the American Society of Pension Actuaries.

Mr. SAMUELS. Mrs. Johnson, the proposal on cross testing relates to defined-contribution plans, and there are a number of articles that we have placed in the record that clearly indicate that recent proposals by creative practitioners have developed what I think we all agree are abusive situations, and our proposal is to deal with the abusive situations.

Mrs. JOHNSON. The history of pensions in the small business sector is that government is always trying to deal with the exception to the point that small business can't deal with offering pension benefits to their employees.

So I would appreciate your recommendation as to how we change or eliminate the nondiscrimination provisions or do something far simpler so that we don't keep correcting problems and forcing small companies out, but do something that simplifies and makes pension plans possible for small companies.

Let me just conclude by saying, Mr. Chairman, that I sympathize with the comments of Mr. Jefferson, and I don't think the issue of public plans can be left. The total unfunded liability in public

plans, local, State, and Federal is $800 billion to $1 trillion, and yet we are looking at the private sector's $53 billion.

So I think we can't just say we are only going to deal with this because this is what the pension benefit guarantee law has traditionally dealt with. We need to make some decisions about whether public plans should be allowed to expand retirement benefits when they aren't funding current retirement benefits.

So I think we need to think about that a little bit as we move through this bill. Certainly I think it would be negligent of our duty not to look at the scandalous problems that are developing in publicly funded pension plans.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you, Ms. Johnson.

Mr. Samuels, one last question, with respect to cross testing, I think it is a good provision of the bill. We ought to try to eliminate discrimination any way we can.

I raise the question with you, why do you ask for cross testing prohibition in this particular legislation if it does not do any violation to the antidiscrimination rules which we passed recently?

Mr. SAMUELS. I think that the concern is if we don't deal with this cross-testing problem now, and as I say, this is a new development and we need to nip it in the bud, if we don't do that, you will see companies moving from defined-benefit plans to defined-contribution plans, thereby eroding the premium base of the PBGC.

Mr. PICKLE. I understand. Well now, I again I want to say to the panel, I thank you very much for your testimony.

Secretary Reich, you were good to come here and stay with us for these 2, 2½ hours. I think it is important legislation, and your leadership and your task force has given us this bill that I hope this committee can consider favorably and move out as quickly as possible.

Secretary REICH. If I may, Mr. Pickle, again, I want to commend you for your tenacity. This issue is a growing issue. It is a problem. We have been on this for years.

I want to commend you and the vigilance of other members of the committee. If I could just summarize in a sense, this is not a crisis yet, but it is a cause for very serious concern. It will become a crisis if we don't address it, and some people may feel that our solution is overly harsh and overly burdensome.

Some people may feel it is overly lenient and it gives companies too much leniency. We think we have struck a proper balance exactly in the center, responsibly, so that we can get these pensions funded fully.

Thank you.

Mr. PICKLE. I appreciate your statement.

Some of the members have raised questions that we would like to have additional responses from all three of you as quickly as you can get them back to us.

Thank you very much for your testimony.

Now, the Chair is going to say, we are going to take a 10-minute, 15-minute recess here. The House has a vote on and we will go to the floor, but we will resume again within 15 minutes, just give a little respite for everybody.

[Recess.]

Mr. PICKLE. The Chair would ask the subcommittee to please come to order again. The testimony this morning has been full and complete, but it has taken a little time.

The Chair wants to say to the committee that we are supposed to be out of this room by 2 or 2:30, or around that time.

We have three panels to be heard from, so we will try to move along as quickly as we can.

We appreciate the patience of the people who are going to testify now. Now we are to going to hear from Joseph Delfico, Director of the Income Security Issues of the Health, Education and Human Services [HEH] Division of the General Accounting Office.

So Mr. Delfico, we are pleased to have your statement and your appearance with us again.

Mr. Delfico.

STATEMENT OF JOSEPH F. DELFICO, DIRECTOR, INCOME SECURITY ISSUES, HEALTH, EDUCATION AND HUMAN SERVICES DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. DELFICO. Thank you, Mr. Chairman. I would like to submit my full statement for the record and give you a 5-minute summary.

Mr. PICKLE. Without objection, it will be submitted.

Mr. DELFICO. Thank you for inviting me here today to discuss the administration's proposed pension reform legislation contained in H.R. 3396, the Retirement Protection Act of 1993.

With me today is Donald Snyder on my right who is the director of my pension work and Michael Packard, our staff economist who helped prepare this testimony. Also with me today are John Wood and Roger Thomas, who helped prepare this testimony.

At your request, GAO has been studying funding issues for underfunded pension plans, the legislation before the committee, and we are going to be issuing a report on this subject in the near future.

Mr. Chairman, in my testimony today, I would like to make three main points. First, current rules designed to ensure that sponsors of underfunded plans make additional contributions to better fund their plans are not working well; second, H.R. 3396, the administration's proposal, should lead to substantial improvements over the current law; and third, H.R. 3396 itself could and should be strengthened.

One of the provisions in the Pension Protection Act was a requirement for sponsors of underfunded plans to make contributions in addition to the minimum contribution required under ERISA. We randomly selected a sample of plans to determine the effectiveness of this provision.

We found that only 40 percent of the sponsors of underfunded plans were making additional contributions under this provision in 1990, and that the amount of additional contribution equaled less than 3 percent of the underfunding in the plans receiving them.

As a matter of fact, Mr. Chairman, we found one plan that was 12 percent funded that hadn't made any additional contributions for 1989 and 1990 under the current law.

The additional funding provision is not working well for two reasons. First, the additional contributions can be reduced by an offset, and under current law, this offset can be much larger than the

required additional contribution. The design of this offset is flawed and must be corrected. In our view——

Mr. PICKLE. Talking about the double counting?

Mr. DELFICO. As the administration refers to it, yes.

Mr. PICKLE. Probably the biggest weakness of the 1987 law.

Mr. DELFICO. I would agree. With regard to funding, it is the main point of our testimony too. In our view, the administration's bill moves in the right direction to address underfunding problems for many underfunded plans.

The bill will do this in two ways. First, it will increase the size of the additional contributions for most plans. It will do this by restricting the allowable interest rate and mortality assumptions plans can use to calculate their liabilities, and by changing the formulas that calculate the additional contribution amount.

Second, it will redesign the offset and eliminate the flaw that currently exists. Mr. Chairman, the redesign of the offset, as I have already said, is the single most important funding provision in the bill and is needed to maintain the integrity of the proposal.

Using our sample, we estimate that compared to current law, the bill will increase the number of plans subject to additional contributions and more than half of these plans will make significant additional contributions.

Despite this improvement, about half of the underfunded plans would not make additional contributions under H.R. 3396. In our view, this is a weakness that should be strengthened. We have some ideas on how this can be accomplished and provide one idea in our written statement today.

The bill contains a number of other provisions, some of which affect funding and some of which do not. Although we have not evaluated all these other provisions on the basis of our previous work, we see value in the provisions that would require plan assets to equal 3 year's disbursements, that would require notification of participants of their plan's funding status and the limitations of PBGC's guarantee, that would require disclosure to PBGC of information necessary to determine current liabilities and assets for certain plans, and that would remove the cap on the variable rate premium.

Mr. Chairman, our work to date suggests that the evidence of funding problems in some plans is sufficiently compelling to support stronger funding requirements for underfunded plans. Stronger funding will not only protect PBGC, but will benefit participants, sponsors of well-funded plans, and the Federal taxpayer as well. H.R. 3396 will make substantial improvements to current funding provisions for underfunded plans, however, we believe that the proposed funding provisions need to be strengthened to ensure that an even greater percentage of underfunded sponsors make additional contributions.

We would be pleased to answer any questions you or other members of the committee may have, Mr. Chairman.

Mr. PICKLE. Thank you, Mr. Delfico.

[The prepared statement follows:]

**STATEMENT OF JOSEPH F. DELFICO
DIRECTOR, INCOME SECURITY ISSUES
HEALTH, EDUCATION, AND HUMAN SERVICES DIVISION
UNITED STATES GENERAL ACCOUNTING OFFICE**

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss the administration's proposed pension reform legislation, H.R. 3396, the Retirement Protection Act of 1993. The majority of pension plans insured by the Pension Benefit Guaranty Corporation (PBGC) are well funded. However, a significant minority are underfunded, and the level of underfunding in these plans has been growing in recent years. This growth increases PBGC's exposure (the size of its potential claims).

Because of PBGC's large and growing deficit,[1] the size of the exposure it faced from underfunded plans, and its financial system and internal control weaknesses, we placed PBGC on GAO's list of "high-risk" government programs in 1990. It remains there today. We believe PBGC will continue to be at risk until its deficit is reduced and the funding in underfunded plans is significantly improved, and we believe stronger funding requirements are needed for such an improvement to occur.

At the request of the Chairman of your Subcommittee on Oversight, we have been studying funding issues for underfunded defined benefit pension plans and will be issuing a report to him in the near future.[2] Our study looks at the effectiveness of current funding rules and at the impact on plan funding of both the administration's proposal and a separate proposal, H.R. 298, the Pension Funding Improvement Act of 1993. My testimony today is based on our results to date.

Mr. Chairman, I would like to make three main points today. First, current rules designed to ensure that sponsors of underfunded plans make additional contributions to better fund their plans are not working well. Second, H.R. 3396 should lead to substantial improvements over current law. And third, H.R. 3396 itself could and should be strengthened.

HISTORY OF PENSION PLAN FUNDING REGULATIONS

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), only minimal funding rules existed. As a result, participants lost promised benefits if their underfunded plans terminated. Among other provisions, ERISA established firm minimum funding rules and established PBGC to insure the pension benefits of participants in most defined benefit plans. The ERISA funding rules worked as intended for many plans, but by the mid-1980s it became apparent that they did not work well for some plans.

In an attempt to further protect PBGC and bolster funding levels in underfunded plans, the Congress enacted the Pension Protection Act (PPA), a part of the Omnibus Budget Reconciliation Act of 1987. Among the act's provisions was an additional funding requirement for large (101 or more participants) underfunded plans. Sponsors of these underfunded plans not only had to make the contribution dictated by ERISA's minimum funding rules (specified in sec. 412(b) of the Internal Revenue Code (IRC), they had to determine if they were required to make additional contributions (specified in sec. 412(l) of the IRC), which are contingent upon both the level of plan underfunding and when it was incurred.

Plans subject to the additional funding requirement first determine their deficit reduction contribution (DRC), the

[1]The deficit in PBGC's Single-Employer Program was $2.9 billion on Sep. 30, 1993.

[2]In a defined benefit pension plan, benefits are generally based on a formula that takes into consideration job tenure and/or earnings.

additional contribution before any adjustments are made.[3] The DRC is reduced by subtracting selected components of the plan's minimum required contribution under ERISA. This reduction amount is called an offset.[4,5]

The expectation was that this additional funding requirement would help to accelerate the movement of underfunded plans toward full funding. The Congress' expectation has not been realized. PBGC reports that underfunding in the single-employer plans it insures increased from $31 billion in 1990 to over $50 billion at the end of 1992. Although this increase is due in part to declining interest rates, the trend is cause for concern.

SHORTCOMINGS IN THE CURRENT LAW

To determine the effectiveness of the Pension Protection Act's additional funding requirement, we randomly selected a sample of 93 plans from the approximately 5,000 large plans that were making variable rate premium payments to PBGC in 1990.[6] Fifty-seven of these 93 plans had unfunded current liabilities and, therefore, were subject to the additional funding requirement. We focused our analysis on three factors that can influence the size of additional contributions--the offset, splitting plan underfunding into old and new components, and interest rates.

We found that the current law offset completely eliminated additional contributions for sponsors of 34 plans in our sample that were subject to the additional funding requirement (60 percent) and reduced them substantially for 16 others (28 percent). Sponsors of only 22 plans in our sample made additional contributions in 1990,[7] and these additional contributions equaled only 2.6 percent of the underfunding in those 22 plans.

This suggests, in our view, that the design of the offset is flawed. Under current law, the offset can be much larger than the DRC because, for most underfunded plans in our sample, the offset contains most of the amortization charges included in the ERISA minimum contribution but few of the counteracting amortization credits. The offset should, at a minimum, include all amortization charges and all amortization credits in the ERISA minimum contribution.

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[3]The DRC is comprised of a payment for the plan's underfunding at the beginning of the 1988 plan year, amortized over 18 years, and a payment for any new underfunding amortized over a shorter period that depends on the ratio of plan assets to plan liabilities (the plan's funding ratio). We estimate that between 2,500 and 3,600 plans were subject to the additional funding provision in 1990.

[4]Components of the offset (for example, the amortization payment to reduce unfunded past service liabilities arising from plan amendments) are listed in sec. 412(l)(1)(A)(ii) of the IRC.

[5]If the plan has an unpredictable contingent event payment (usually caused by a plant shutdown), an additional payment is added to the net amount computed. The net DRC is then tested to ensure that it does not exceed the beginning-of-year underfunding in the plan. Finally, it is reduced for plans with not more than 150 participants.

[6]The variable rate premium, which depends on the per participant level of plan underfunding, is an additional premium paid to PBGC by underfunded plans. The measure of underfunding differs from that used to determine if additional contributions should be made.

[7]Another sponsor should have made additional contributions, but did not because the instructions were misinterpreted.

Also, splitting a plan's liability into old and new components reduced both the size of additional contributions and the number of sponsors who would make them. Because this provision is transitional and is designed to phase out, we do not believe it needs to be modified.

Finally, in 1990 plans were not using high interest rates to avoid making additional contributions. Only about 25 percent of the plans in our sample used an interest rate in the top half of the allowable range, and only two plans used the highest permitted rate.

PROPOSED LEGISLATION TO IMPROVE FUNDING

Two bills before the Congress address the shortcomings in the current law: H.R. 298, the Pension Funding Improvement Act, and H.R. 3396, the Retirement Protection Act. Our analysis indicates that H.R. 298 would affect even fewer plans than the current law, but would cause substantially increased contributions for sponsors that would be affected (see table 1). H.R. 3396, on the other hand, would increase the number of sponsors of underfunded plans making additional contributions and would also substantially increase the amount of additional contributions, although not so much as H.R. 298.

Our analysis suggests that the administration's bill, H.R. 3396, moves in the right direction in addressing the underfunding problem for many underfunded plans. Indeed, most funding provisions in the bill will affect only underfunded plans. In addition, because the funding proposals only modify the structure of current law, practitioners will not have to learn a new system. Most importantly, the bill corrects the current law offset's design flaw. In our view, the redesign of the offset is the single most important funding provision in the bill and is needed, as is, to maintain the integrity of the proposal.

The bill also contains several other provisions that can increase contributions to underfunded plans. These include a solvency rule, restrictions on actuarial assumptions, an increase in the deficit reduction contribution for many plans, and the immediate recognition of benefit increases.

The solvency rule would require that plan's liquid assets equal at least 3 years' disbursements. Our earlier work on hidden liabilities in pension plans demonstrated that underfunding can increase rapidly in many plans immediately before termination.[8] The solvency rule would provide that a cushion of assets be maintained to protect plan participants and the PBGC. Only one plan in our sample would have received a solvency rule contribution under this provision in 1990.

The restrictions on actuarial assumptions would dictate that plans determine their current liabilities using a specified mortality table and the lower half of the current allowable interest rate range. These restrictions would increase current liabilities for most plans in our sample and would increase the number of plans subject to the additional contribution provision.

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[8]Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Program (GAO/HRD-93-7, Dec. 30, 1992).

Table 1: Comparative Effects of Additional Funding Requirements Under Current Law, H.R. 298, and H.R. 3396, Based on a Sample of 93 Plans in 1990

	Provision		
	Current Law	H.R. 298	H.R. 3396
Number of plans subject to additional funding requirement	57	59	65
Total underfunding (all plans)	$201.6 M	$215.0 M	$255.6 M
Number of plans receiving additional contributions	22	16	34
Total underfunding in plans receiving additional contributions	$106.5 M	$158.0 M	$221.6 M
Total additional contributions	$2.8 M	$44.7 M	$28.0 M
Additional contribution as a percent of underfunding (in plans receiving them)	2.6%	28.3%	12.6%

The administration's bill would also increase the DRC for plans whose funding ratios exceed 35 percent and would require immediate recognition of all bargained benefit increases, even if part of the increase does not take effect for several years. The first provision would increase additional contributions for most sponsors making them. The second would accelerate funding in negotiated plans, which generally are flat benefit plans,[9] a type of plan particularly susceptible to underfunding.

We used our sample of plans to estimate the impact of the administration's bill had it been in effect in 1990. The actuarial assumption restrictions would have increased the number of plans subject to the additional contribution provision from 57 to 65. Sponsors of 34 of these 65 plans (52 percent) would have made additional contributions equal to about 12.6 percent of the plans' underfunding. Sponsors of all plans in our sample with funding ratios of less than 50 percent would make additional contributions, while sponsors of half the plans with funding ratios between 50 and 75 percent and about 40 percent of those whose plans had funding ratios above 75 percent would make additional contributions.

Further Strengthening of Funding Rules Desirable

Despite the funding improvements the administration's bill would bring, sponsors of some marginally funded plans would still not make additional contributions. These sponsors may make

[9]Flat benefit plans generally pay a specified dollar amount per year of service.

additional contributions at some point in the future under H.R. 3396, but we are concerned that some plans may never become fully funded unless they do.

Sponsors of only about 40 percent of the 57 underfunded plans in our sample make additional contributions under current law. The administration's proposal would, we estimate, increase both the number of plans subject to the additional contribution provision and the percentage making additional contributions. Based on our sample, the number of plans subject to the provisions will increase by about 15 percent, and between 50 and 60 percent of this higher number will make additional contributions.[10] With time, this percentage could increase further (because of the elimination of the unfunded old liability component of the DRC, for example).

Nevertheless, sponsors of some plans with relatively low funding ratios will not make additional contributions because their offsets will continue to exceed their DRCs. For example, one plan in our sample, which did not receive additional contributions in 1989 or 1990 and that would not receive additional contributions under H.R. 3396, had a funding ratio that declined from 58 percent in 1988 to 55 percent in 1990. The ERISA minimum contribution did not improve funding in this plan from 1988 to 1990, and we have no reason to believe that this contribution alone will improve the plan's funding in the future. In our opinion, this plan should be receiving additional contributions to bolster its funding.

The most direct way to rectify this problem is to require that sponsors of all plans with funding ratios below a specified threshold, say 80 percent, make an additional contribution to improve their plans' funding. This could be accomplished by capping the offset at a certain percentage of the DRC. This modification would cause sponsors of all plans with funding ratios below 80 percent to make an additional contribution.

In our sample, sponsors of 75 percent of the underfunded plans would make additional contributions (see fig. 1). Those that would not make additional contributions have plans that are at least 80 percent funded. Figure 2 shows additional contributions as a percent of underfunding (for plans receiving additional contributions) under current law, the H.R. 3396 proposal, and an example of a strengthened proposal with the offset cap set at 50 percent of DRC.

While this approach will increase additional contributions by sponsors that might not make them otherwise, it will also reduce federal revenues because these contributions are tax deductible. The lower the level of the cap on the offset, the higher will be the additional contributions and revenue loss. To address this issue, the Congress would ultimately have to balance the budget's PAYGO (pay-as-you-go) considerations against improved protections for PBGC and participants in underfunded plans.[11]

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[10]Sponsors of 52 percent of the underfunded plans in our sample would make additional contributions with the bill's proposed transitional limitations in place. These limitations would restrict the level of additional contributions through the 2001 plan year. Without these restrictions, sponsors of 38 of the 65 underfunded plans (58 percent) would make additional contributions.

[11]Under the Budget Enforcement Act, PAYGO requires that all direct spending and tax legislation enacted during a session of the Congress must be deficit-neutral in the aggregate.

Figure 1: Estimated Percentage of Underfunded Plans Receiving Additional Contributions Under Current Law, H.R. 3396, and H.R. 3396 Modified So That All Plans Less Than 80 Percent Funded Receive Additional Contributions

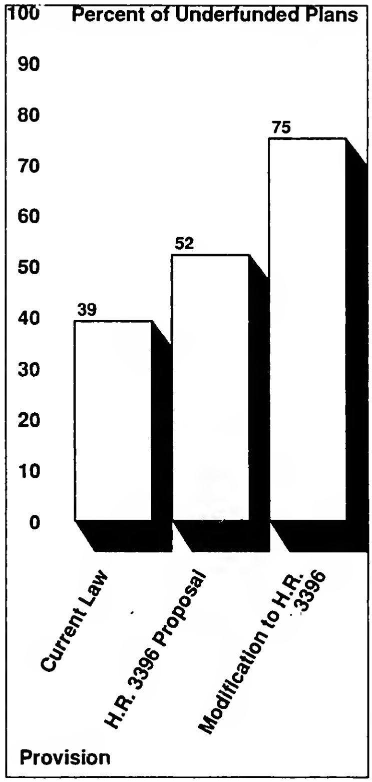
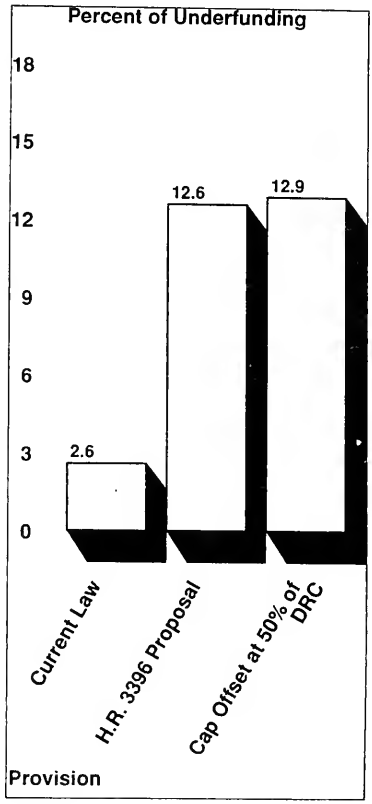


Figure 2: Estimated Additional Contributions as a Percent of Underfunding Under Current Law, H.R. 3396, and H.R. 3396 Modified So That the Offset Is Capped for Plans With Funding Ratios of Less Than 80 Percent



The administration's bill contains a number of proposals that do not impinge on plan funding. Although we have not evaluated all of these other provisions, on the basis of our previous work, we see value in the provisions that would (1) require notification of participants of their plan's funding status and the limitations of PBGC's guarantee, (2) require disclosure to PBGC of information necessary to determine current liabilities and assets for certain plans, and (3) remove the cap on the variable rate premium.

CONCLUSION

Our work to date suggests that the evidence of funding problems in some plans is sufficiently compelling to support stronger funding requirements for underfunded plans. PBGC calculations show that underfunding in the plans it insures is increasing in spite of provisions in the 1987 Pension Protection Act and is now over $50 billion. Continued and growing underfunding has several negative impacts. It (1) increases PBGC's exposure, (2) puts plan participants at risk of losing benefits not guaranteed by PBGC, (3) may result in premium increases for well-funded plans (to reduce PBGC's losses), and (4) might eventually result in the remote possibility of a taxpayer bailout of PBGC should the agency run out of assets to pay benefits. Improving the funding of underfunded plans would benefit each of these groups.

The additional contribution provision of the 1987 Pension Protection Act appears to be having less impact than envisioned on improving funding in underfunded plans. The proposed funding provisions in the administration's Retirement Protection Act, especially the revised offset design, should increase both the number of sponsors of underfunded plans that make additional contributions and the amount of these additional contributions. However, based on our sample, sponsors of half the plans that are 50 to 75 percent funded will not make additional contributions under the proposed funding rule changes. As a result, we believe the proposed funding provisions need to be strengthened further to ensure that an even greater percentage of underfunded plans' sponsors make additional contributions.

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Mr. Chairman, this concludes my statement. I will be happy to answer any questions you or other Committee members may have.

(105659)

Mr. PICKLE. When you stated that this bill, H.R. 3396, should lead to substantial improvements over the current law, and last you say it should be strengthened——

Mr. DELFICO. Yes.

Mr. PICKLE. In what way should the bill be strengthened?

Mr. DELFICO. Mr. Chairman, we have an example of how the bill could be strengthened by requiring more underfunded plans to make the deficit reduction contribution. We propose limiting the offsets in the deficit reduction contributions, the offsets that are now, we feel, the largest, biggest flaw in the 1987 legislation, and——

Mr. PICKLE. You go further than the recommendation that Treasury has made now?

Mr. DELFICO. Yes, we do.

Mr. PICKLE. Is that explained in your written testimony?

Mr. DELFICO. Mr. Chairman, it is.

Mr. PICKLE. Good.

Mr. DELFICO. We have a recommendation there that we hope could improve funding even more and capture about 75 percent to 80 percent, depending on how the Congress wants to go, of the underfunded plans.

Mr. PICKLE. Did I understand you to say that some of the plans, underfunded plans, actually the percentage of contribution is way below the 60? Or what level did you say many of these plans are now?

Mr. DELFICO. The plans in our sample for the analysis of the 1987 legislation range anywhere, I think, from 12 percent all the way up to about 80 percent, but as I mentioned, the 12 percent plan was one that did not make any additional contributions for the 2 years we looked at it.

Mr. PICKLE. In your testimony, you stated that current laws or rules to insure the sponsors of underfunded plans increase funding to the plan are not working, yet we do have some complaints from some businesses that say that in light of the Pension Protection Act of 1987, and due to the reporting requirements of both PBGC and the SEC and others, that they are voluntarily funding the underfunded liability, and that they don't need any legislation.

Do you agree with that?

Mr. DELFICO. Mr. Chairman, I don't agree with not needing legislation in that respect. I think we do need to press forward in that area.

Mr. PICKLE. I make this observation myself that the 1987 law is a good law. It did require a lot of plans to get funded that were not being funded, and I think most of the plans are meeting that challenge. Eighty-five to 90 percent of them are fully funded.

We did lose a few plans at that point and that was a big fear at the time, but most of them are perhaps plans that would have gone by the wayside anyway. Now, that the big majority of them are meeting the rules, we have got to see that it is spread to others.

I think if we were to change the cross testing with respect to defined- contribution plans, the double counting and the insurance premiums, that we would come close to closing those gaps, and I hope that is what we will do, and in fact this legislation will do it.

I want to read with interest your suggestion to further strengthen this, so I appreciate that.

Mr. Kleczka.

Mr. KLECZKA. Mr. Chairman, I am still unclear as to the proposal by—the recommendation by GAO to strengthen the underfunding by those companies.

Would you explain to me further what you are proposing or what you would like to see us do?

Mr. DELFICO. Gladly. Mr. Kleczka, what we did was we took a sample of plans, this is a random sample and a representative sample of plans, and we took the statistics of those plans and we ran them through a model that simulated the proposed legislation.

We found that under the proposed legislation, just over half of those plans, the underfunded plans in our sample, would be making additional contributions. About 48 percent of them would not make additional contributions, even under the administration's plans. That was based on a random sample of about 65 plans that we were looking at.

Now, given the fact that 48 percent were not making additional contributions, we thought that we would—you could take a look at the real problem, and that was the offset, again, although the administration's——

Mr. KLECZKA. That is taken care of in the bill, right?

Mr. DELFICO. Right, and to make sure the deficit reduction contribution is paid by a certain percentage of the plans, and that percentage is a variable depending on what Congress would like.

In our example, we said any plan that is 80 percent funded or below should pay at least something in a deficit reduction contribution. They should, in other words, not offset that deficit reduction contribution beyond a certain amount.

And so what we did was we just took two numbers. We took the percentage of plans that were subject to that particular situation, say that were less than 80 percent funded, and then in our example we used a 50 percent deficit reduction contribution limitation and said that these plans had to make at least 50 percent of that deficit reduction contribution regardless of what the offset provision was.

Mr. KLECZKA. How do we amend the bill to bring those 40 percent under the fold? By using the 80 percent?

Mr. DELFICO. Eighty percent, right. We could work with you on that, work with some language on it.

Mr. KLECZKA. Have you shared this with the PBGC and Labor and Treasury, and what type of reaction are you getting?

Mr. DELFICO. We shared it with both PBGC and Treasury. We have been working with them now for the past 6 weeks on this particular issue, and their reaction has been somewhat favorable on doing it.

They still are looking at our database to try to determine how the plans that we say have not made additional contributions got through their particular legislative screens, and we are still working with them on that, but I think we are making some solid progress.

Mr. KLECZKA. Maybe between now and the actual markup of the legislation, we could have some verdict from those two agencies to see whether or not they would be supportive.

Mr. DELFICO. We will work it any way that you like.

Mr. KLECZKA. We are not going to pass the PBGC every year. So if we are going to do it, Mr. Chairman, we ought to be as comprehensive as we can.

Mr. DELFICO. I will be glad to work with you.

Mr. PICKLE. Mr. Delfico, one last question.

Some of the companies have complained that we ought not to make companies change their mortality or interest assumptions, that we ought to let them choose their own.

How can we guarantee that those rates won't be used in economic times of distress to a company's own benefit without legislation that would prohibit it?

Mr. DELFICO. I don't think there is a guarantee, Mr. Chairman.

I think that the proposal of PBGC to use a mortality table, which I think is the GAM 1983, is consistent with the mortality table that they use for establishing termination liabilities.

Mr. PICKLE. Well, if Congress were to decide to use a single mortality table, does GAO have one that you would suggest we would use as a guide or a model?

Mr. DELFICO. No, we don't, Mr. Chairman. We don't have one that we would suggest to use. We would defer to PBGC on that one.

Mr. PICKLE. Well, we will keep in touch with you. I noticed one of the members this morning who surprised me and in effect said he thought this was good legislation. He also pointed out though, that he had a deep concern about mortality tables.

It is a problem I think in some instances we ought to consider, because we ought not to be unfair about it, but the abilities for a company to change their interest rates or the mortality table just because times get tough does give them a chance to alter the solvency of the pension funds, and that is what happens. So that is why we are trying to tighten it up.

I appreciate your testimony very much and you have appeared before us before, you are familiar with this, and your testimony is very helpful.

Thank you very much.

Now the Chair would recognize the first panel. I hope all the panel members are still here. This next panel consists of Mr.—the representative of the American Institute of Certified Public Accountants, then the—and also in this panel will be the—Harvey Coustan and Deborah Walker.

Another member of the panel, the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, the UAW, Mr. Hoffmann.

Then there is the testimony from Curtis Barnette, representing the Pension Issues Coalition, and then testimony from Michael Gulotta, representing the Financial Executives Institute, the Committee on Employee Benefits.

First we will hear from the CPAs, Harry Coustan, Harvey Coustan. I believe Mr. Coustan has served on the IRS Civil Penalty Task Force and was instrumental in shaping the package of pack-

ing reforms known as Impact, which was a very successful piece of legislation and I appreciate, Mr. Coustan, your help on that. It was very helpful to us, and I am glad to have you back with us.

STATEMENT OF HARVEY L. COUSTAN, CHAIRMAN, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY DEBORAH WALKER, VICE CHAIRMAN, TAX EXECUTIVE COMMITTEE

Mr. COUSTAN. I appreciate that acknowledgment, Mr. Chairman.

Mr. PICKLE. I will also add that Deborah Walker testified last year during our hearing on the nonfilers, so we are glad to have you again, Ms. Walker.

Now, Mr. Coustan.

Mr. COUSTAN. My name is Harvey Coustan. I am testifying on behalf of the American Institute of Certified Public Accountants, that is the AICPA, as chairman of its tax division.

Joining me today is Deborah Walker, vice chair of the Tax Division and an acknowledged expert on ERISA and retirement income matters.

The AICPA appreciates the opportunity to comment on H.R. 3396, the Retirement Protection Act of 1993, and our comments represent the views of our Employee Benefits Plan Committee as well as those of the tax division.

AICPA is the national professional organization of CPAs with over 314,000 members in practice, industry, government, and education. For years, the AICPA has been a strong advocate of simplification of the pension system.

We believe this proposal achieves simplification in some areas, while creating complexity in others. We also believe that while this bill addresses some of the issues affecting plan funding, additional important steps can and should be taken to ensure that the necessary funds are put aside by plan sponsors to pay the benefits promised to American workers.

In addition, specific measures need to be adopted to correct a shortfall in the information employees need to have about their pensions. Workers have every right to know whether their pensions are secure. Only then can they make informed choices about their retirement and their future.

Last April we launched an effort encouraging workers to educate themselves about their pensions and warning that if their nest egg is rotten, the time to find out is now, and not when they retire.

Specifically, the AICPA offered a series of recommendations to increase the amount of information available to plan participants about the financial status of their plans, including how much the plan has promised to pay participants and whether it is adequately funded to meet those promises, whether its investments are sound and whether the plan is insured by the PBGC.

Having such information would enable workers to encourage their employers to adequately fund their pension plans and allow them to plan supplemental sources of retirement income. Our comments and suggestions relate to several sections of the bill, including the elimination of cross testing, exemption from the quarterly funding requirement and other funding criteria, exemption from the 10 percent excise tax on certain nondeductible contributions,

cost of living adjustment rules, and increased disclosures to plan participants.

Mr. PICKLE. You support all those changes?

Mr. COUSTAN. Support all the ones I suggested. No, we will get to that in a moment, sir.

The AICPA opposes the elimination of the cross-testing method for discrimination testing in qualified retirement plans and objects on tax policy and on legislative procedural grounds.

First, as a matter of tax policy, the elimination of the ability to cross test employee benefit plans would result in the termination of a significant number of qualified retirement plans, a substantially worse result than exists at present.

The tax system includes significant and important incentives for employers and business owners to provide retirement security for employees, and we believe it critical that those incentives continue.

Second, as a matter of legislative procedure, Congress should not repeal a single element of a comprehensive set of Internal Revenue Service regulations that were carefully designed to implement existing law. Legislative changes such as this should be considered only as part of a deliberate review of the country's overall retirement income policy which to date has not been considered.

The act proposes to improve plan funding levels, including rules that would encourage more rapid funding and the use of more standardized actuarial assumptions. We applaud these suggestions and recommend that they be given serious consideration, that a termination of the standardized actuarial assumptions is something which probably needs some further review.

At the same time, however, there are several current statutory provisions that discourage employers from fully funding defined-benefit plans. Two such provisions are, first, the 150 percent full funding limitation which disallows deductions for employer contributions that exceed 150 percent of current liabilities; second, the 50 percent reversion penalty, which is a disincentive to fully funding defined-benefit plans under certain circumstances.

These areas are covered in greater detail in our written testimony.

The AICPA strongly supports both proposals since they will remove impediments to full funding by employers who may have previously hesitated to maximize their contribution to a defined-benefit plan because elected deferrals or matching contributions might not be deductible and could be subject to the 10 percent excise tax.

Again, simplification is achieved as well.

The AICPA supports amendments that will encourage plan sponsors to bring all plans up to a true full funding status. The AICPA believes such changes should be a high priority for the Congress and is willing to assist the Congress in identifying and analyzing potential legislative proposals designed to achieve the full funding objectives.

The AICPA supports repealing the requirement for quarterly contributions to fully funded plans since this proposal would achieve simplification for many employers.

Currently, employers who contribute too much on a quarterly basis need to file a ruling request from the IRS to receive a refund from the nondeductible contribution to the plan. The AICPA takes

issue with changing the rounding rules for annual cost of living adjustments to the section 415 limits on contributions and benefits and to the elective deferral limits. We recommend rounding to $100 increments.

Although this provision appears to simplify pension administration, we are concerned that it is being used as a back door attempt to generate additional revenue. Worse, it is becoming clear that this is deliberate governmental policy.

The 1993 Budget Reconciliation Act, in applying the new $150,000 compensation cap for qualified plan purposes, also required indexing in increments, rather than annually. Since indexing provisions affect the amount ultimately received by retired workers and since indexation has traditionally been an annual event for Social Security COLAs, that is cost of living increases, brackets creep and even before 1994 for compensation taken into account for qualified plan purposes, we believe a shift to a more restrictive approach, without a good deal of education of the taxpaying public, is inappropriate.

That concludes our oral testimony, Mr. Chairman.

Mr. PICKLE. I thank you very much for your testimony, Mr. Coustan.

[The prepared statement follows:]

STATEMENT OF HARVEY COUSTAN
CHAIRMAN, TAX DIVISION
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

My name is Harvey Coustan. I am testifying on behalf of the American Institute of Certified Public Accountants (AICPA), as Chairman of its Tax Division. The AICPA appreciates the opportunity to comment on H.R. 3396, "The Retirement Protection Act of 1993." The AICPA is the national professional organization of CPAs, with over 314,000 members in practice, industry, government and education. For years, the AICPA has been a strong advocate of simplification of the pension system. We believe this proposal achieves simplification in some areas, while creating complexity in others. We also believe that while this bill addresses some of the issues affecting plan funding, additional important steps can and should be taken to ensure that the necessary funds are put aside by plan sponsors to pay the benefits promised to American workers. In addition, specific measures need to be adopted to correct a shortfall in the information provided to employees about their pensions. Workers have every right to know whether their pensions are secure. Only then can they make informed choices about their retirement and their future.

Our comments and suggestions relate to several sections of the bill including the elimination of cross testing, exemption from the quarterly funding requirement and other funding criteria, exemption from the 10 percent excise tax on certain nondeductible contributions, cost-of-living adjustment rules and increased disclosures to plan participants.

ELIMINATION OF CROSS-TESTING

Section 408 of the Retirement Protection Act, proposed in 1993, would eliminate the cross-testing method for discrimination testing in qualified retirement plans. The AICPA opposes the elimination of cross testing and objects to section 408 both on tax policy and on legislative procedural grounds. First, as a matter of tax policy, the elimination of the ability to cross-test employee benefit plans would have some undesirable consequences. Second, as a matter of legislative procedure, Congress should not repeal a single element of a comprehensive set of IRS regulations that were carefully designed to implement existing law.

Tax Policy

Some in Congress may be concerned that the application of cross testing principles could result in lower contributions being allocated to younger workers. For the following reasons, however, we believe these concerns are misplaced:

- Over an individual's working life, funding for a specific retirement benefit would be the same. In the course of a worker's total years of employment, he or she would enjoy a nondiscriminatory retirement benefit.

- These concepts are fundamental to defined benefit plans designed by employers to maximize retirement benefits for the employees most in need of retirement savings, the older workers. Yet, the proposed elimination is only directed at defined contribution plans.

There has been a long-standing statutory premise that, in testing to determine whether a plan is discriminatory, the employer can prove that either contributions or benefits do not discriminate in favor of highly compensated employees. The employer does not have to prove that <u>both</u> contributions and benefits are nondiscriminatory. The statute does not require that defined benefit plans be tested on the basis of benefits or that defined contribution plans be tested on the basis of contributions.

The inevitable result of eliminating cross testing will, in our view, be termination of a significant number of qualified retirement plans – a substantially worse result than exists at present. The tax system includes significant and important incentives for employers and business owners to provide retirement security for employees, and we believe it critical that those incentives continue.

Legislative Procedure

After the enactment of the Tax Reform Act of 1986, the Internal Revenue Service undertook a comprehensive review of qualified plan discrimination rules. It was decided that very specific rules should detail appropriate discrimination tests. These rules resulted in over 600 pages of regulations,

which were reviewed, subjected to public comment, and revised over a four-year period. These regulations outline in precise detail how a plan sponsor can test benefits to determine whether the contributions are discriminatory. These discrimination testing concepts have been in place since the issuance of Rev. Rul. 81-202.

The AICPA particularly objects to legislative repeal of one segment of an extremely comprehensive regulation project. Legislative changes such as this should be considered only as part of a deliberate review of the country's overall retirement income policy, which to date has not been considered.

PLAN FUNDING

The Act proposes reforms to improve plan funding levels, including rules that would encourage more rapid funding and the use of more standardized actuarial assumptions. We applaud these suggestions and recommend that they be given serious consideration.

At the same time, however, there are several current statutory provisions that discourage employers from fully funding defined benefit plans. Two such provisions are:

- The 150% full funding limitation, which disallows deductions for employer contributions that exceed 150% of "current liabilities." The term "full funding" in this context does not mean that the plan has enough funds to pay all benefits when they become due, because full funding is based on an artificial assumption of the plan terminating today and an arbitrary 150% cap.

- The 50% reversion penalty is a disincentive to fully funding defined benefit plans under certain circumstances. Under current law, these excise taxes are still applicable even if the employer uses any related reversion amounts to enhance the security of other employee benefit programs (for example, retiree health care).

Given the above, businesses desiring to improve the financial strength of their pension plans in good times are precluded or dissuaded from doing so, only to find they are not able to continue to provide the necessary funds for workers' retirements when the economy turns down.

We recognize that the Congress must consider competing interests, including tax revenue and related budget implications, adequacy of the Pension Benefit Guaranty Corporation's insurance fund, the cost to plan sponsors of providing retirement benefits and relevant labor and social policy considerations. We believe that the need for adequate funding of pension plans should be the focus of increased Congressional emphasis to ensure that participants receive promised benefits.

We understand that removing certain disincentives may result in decreased tax revenues. However, we believe that the situation is such that we must "pay now or pay later," and there is serious potential for a far greater cost to the American taxpayers if plan funding is not improved in the near term.

We believe that a comprehensive assessment should consider both the need to strengthen the minimum funding standards and the need to remove disincentives to full funding. This includes consideration of the maximum deduction limits and carryforward provisions for any excess contributions.

In the context of removing disincentives, we are pleased that section 105 of the Act eliminates the current 10% excise tax on certain nondeductible contributions to both a company's defined benefit and defined contribution plan exceeding 25% of payroll, and eliminates the same excise tax on nondeductible contributions for plans with fewer than 100 participants that fully fund all benefit liabilities upon plan termination. The AICPA strongly supports both proposals, since they will remove impediments to a full funding by employers who may have previously hesitated to maximize their contributions to a defined benefit plan because elective deferrals or matching contributions might not be deductible and could be subject to the 10 percent excise tax. Moreover, simplification is achieved as well.

The AICPA supports amendments that will encourage plan sponsors to bring all plans up to a true full funding status. The AICPA believes such changes should be a high priority for the Congress and is willing to assist the Congress in identifying and analyzing potential legislative proposals designed to achieve the full funding objective.

EXEMPTION FROM QUARTERLY FUNDING

Section 104 of the Act repeals the requirement for quarterly contributions to fully funded plans. The AICPA supports this proposal since it would achieve simplification for many employers. Currently, employers who contribute too much on a quarterly basis need to file a ruling request with the IRS to receive a refund of the nondeductible contribution to the plan.

AMENDMENTS TO ROUNDING RULES

Section 407 of the Act changes the rounding rules for annual cost-of-living adjustments to the section 415 limits on contributions and benefits and to the elective deferral limits. The $90,000 defined benefit and $30,000 defined contribution dollar limitations under section 415 would be indexed in $5,000 increments; the $7,000 limit on elective deferrals would be indexed in $500 increments. In principle, the indexed amount would be adjusted by rounding <u>down</u> to the next lowest multiple (but never up). For example, if this provision were to be effective in 1994, the limit on elective deferrals, which is $9,240, would be held at $9,000 until the indexed amount would otherwise exceed $9,500. We recommend rounding to $100 increments.

Although this provision appears to simplify pension administration, we are concerned that it is being used as a back-door attempt to generate additional revenue. Worse, it is becoming clearer that this is deliberate governmental policy. The 1993 Budget Reconciliation Act, in applying the new $150,000 compensation cap for qualified plan purposes, also required indexing in increments, rather than annually. Since indexing provisions affect the amount ultimately received by retired workers, and since indexation has traditionally been an annual event (for social security COLAs, bracket creep, and even (before 1994) for compensation taken into account for qualified plan purposes), we believe a shift to a more restrictive approach - without a good deal of education of the taxpaying public - is inappropriate.

DISCLOSURES TO PLAN PARTICIPANTS

We support section 301 of the Act, which calls for increased disclosures to defined benefit pension plan participants about their plan's funding status and the limits on the Pension Benefit Guaranty Corporation's (PBGC) guarantee should the plan terminate while underfunded. However, we believe that *all* plan participants should receive additional information about their plans. We emphasize the word "all" because we believe such disclosures should be made to plan participants whether the plan is underfunded or fully funded. Accordingly, we recommend revisions to existing sections of ERISA which are discussed in the following paragraphs.

Most employees do not receive their benefit plan's detailed annual financial statements, which are filed with the U.S. Department of Labor. Instead, they look to the Summary Annual Report (SAR) to obtain financial information about their plan. ERISA section 104(b)(3) requires plans to furnish participants with a SAR, and section 2520.104b-10 of the DOL's Rules and Regulations sets forth the required form and content of the SAR. However, the SAR does not currently include information critical to evaluating the plan's financial health and ability to meet its obligations to participants. The information that is provided, moreover, is often in a format that is difficult to understand. The AICPA believes that the requirements for the form and content of the SAR should be expanded and should be included in ERISA section 104(b)(3). We have a number of recommendations to make the SAR more informative and easily understood by employees.

Specifically, the SAR should:

- Disclose the total amount promised to plan participants in the form of benefits, the accumulated benefit obligation, as well as key actuarial assumptions used to calculate that obligation. Right now, the SAR discloses the plan's assets but not its obligations. Seeing only the amount of assets the plan has, but not how much it owes, the employee cannot possibly assess the plan's financial condition.

- Explicitly disclose the funding status of the pension plan. For example, if the obligations of the plan exceed its assets, the SAR should say that the plan is underfunded and by how much.

- Disclose the maximum monthly benefit guaranteed by the PBGC. If for any reason a pension plan can't make good on its obligations – for example, because the company goes bankrupt or out of business – the worker's last recourse is the PBGC, the government's insurance policy for pension plans. However, this insurance doesn't always cover all the benefits owed to the employee. The SAR for a defined benefit pension plan should provide a description of the PBGC's coverage, specifying any limitations or benefits excluded.

- Disclose if the employer is having financial trouble that could impair its ability to contribute to the pension plan and if the pension plan's assets are concentrated in certain high-risk or illiquid investments.

- Include information on the right of every plan participant to request information on his or her individual benefits once per year.

- Notify the participant of a report by the independent auditor on the plan's financial statements that is other than an unqualified opinion or a disclaimer of opinion in a limited-scope audit under section 103(a)(3)(c) of ERISA.

Information provided in the SAR about the plan itself is not the only information that is relevant to pension plan participants. The information of greatest interest to a defined benefit pension plan participant is how much the plan will pay him or her in retirement. However, current ERISA section 105(a) requiring pension plans to provide participants with individual benefit information doesn't apply to all defined-benefit pension plans. ERISA section 105(d) calls for the Department of Labor to issue regulations to make this requirement applicable to multi-employer pension plans. The Department has issued proposed regulations in 1979 and again in 1980, but it never finalized them. Accordingly, members of multi-employer plans may not have the right to individual benefit information. We recommend that ERISA section 105(d) be deleted to make section 105(a) apply to all defined-benefit pension plans.

In addition, the current rules allow an excessively long delay between the time a major change to a pension plan is adopted and the time the employees learn about it. ERISA section 104(b)(1)(B) requires pension plans to furnish employees a "summary description of plan amendment" not later than seven months after the end of the plan's fiscal year in which the change is adopted. In the extreme case, if a change is adopted on the first day of the plan year, the plan participants would not have to be notified for 19 months.

A pension plan amendment might change the amount of benefits promised by the plan's sponsor; or it might change the plan's sponsor – the company responsible for making contributions to the fund; or the plan administrator – the party the employee sees to exercise his or her rights under the plan. Workers shouldn't have to wait as much as a year and a half to learn of those changes.

Because plan amendments may significantly affect participants' benefits or the stewardship of the pension plan, ERISA section 104(b)(1)(B) should be amended to require notification of plan amendments no more than 90 days after the change is adopted. Further, the rules should clarify what changes are significant enough to warrant such notification.

Mr. PICKLE. Now, do you have any statements, Ms. Walker or are you just accompanying Mr. Coustan?

Ms. WALKER. Just accompanying him.

Mr. COUSTAN. Ms. Walker is really the expert, Mr. Chairman. That is why I brought her along. I feel much more secure with her present.

Mr. PICKLE. We have had the occasion to be working with Ms. Walker before, and both of you have been very helpful to the subcommittee. We appreciate that and we appreciate the testimony you have just given.

STATEMENT OF WILLIAM S. HOFFMAN, PH.D., DIRECTOR, SOCIAL SECURITY DEPARTMENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA [UAW]

Mr. PICKLE. Now, the Chair would recognize Mr. Hoffmann, William Hoffmann, director of the Social Security department of UAW. Mr. Hoffmann.

Mr. HOFFMAN. Thank you, Mr. Chairman. I am director of the Social Security department of the UAW and on behalf of the UAW, I want to thank you for the opportunity to testify today before you on the proposed Retirement Protection Act of 1993 and the problems associated with pension plans that are less than fully funded.

We believe the administration is correct to focus on strengthening the funding rules for pension plans. This is the best way to address the problem of underfunded pension plans. The UAW applauds the administration for taking this positive approach rather than an approach which would cut benefit guarantees or restrict benefit increases.

We strongly oppose proposals to cut the benefit guarantees in the PBGC, and we also strenuously oppose proposals that would restrict benefit increases by encumbering corporate assets. Such proposals would penalize workers and retirees by reducing the security and adequacy of their retirement income.

The problem of underfunding in pension plans has not been caused by overly generous PBGC guarantees. The 5-year phasein of the guarantees provides adequate protection against so-called deathbed benefit increases.

Similarly, the problem of underfunding has not been caused by excessive benefit increases. Over the last two decades, the benefits provided by the UAW big three pension plans have replaced a relatively constant percentage of preretirement income.

Much of the misunderstanding in this area we believe is due to confusion over the difference between salary related plans and flat dollar plans.

Salary-related pension plans provide benefits equal to a set percentage of salary. As salaries grow over time, pension benefits increase automatically. There is no need to amend plans every few years to update the benefit levels. Due to the salary-related formulas, this happens automatically.

Flat dollar plans, like those maintained by the big three auto companies for UAW members, provide benefits based on a flat dollar amount for each year of a worker's service with the company. The benefits provided under these plans do not automatically rise

with the growth in wages. These plans then have to be amended every few years to adjust the benefit levels to keep pace with the growth in wages.

Without these ad hoc increases, the real value of the pension benefits gradually erodes over time as they replace a lower and lower percentage of workers' preretirement earnings.

Thus the criticism that has been directed at the benefit increases negotiated by the UAW with the big three auto companies is unfair. These increases have not been excessive or irresponsible. They have simply updated the benefit levels to keep pace with the growth in wages so that the real purchasing power of the pension benefits has not been eroded. Thus, proposals that would restrict ad hoc increases in flat dollar benefit plans would discriminate against rank and file blue collar workers.

The simple inescapable truth is that flat dollar pension plans are not fully funded because the companies have not contributed sufficient moneys to the plans.

The obvious solution is for Congress to enact legislation requiring quicker, more secure funding of these plans.

Recently, each of the big three auto companies has taken steps to contribute substantially more than the amounts required under ERISA. The UAW has encouraged and welcomed these voluntary efforts, but we believe firmly that there is still a need to strengthen ERISA's minimum funding standards to require companies to improve the funding status of pension plans.

Therefore, we support strongly the tightening of the deficit reduction contribution required under OBRA 1987 to ensure that the plan's funding status actually improves.

We are pleased that the administration has included a transition rule to make sure that the tougher funding rules do not jeopardize the economic viability of companies, but the strengthened funding rules should also provide for a relatively stable and predictable funding requirement.

Under the proposed transition rules, future increases in liabilities could result in dramatic swings in required contributions from one year to another. Therefore, some leveling or smoothing out is necessary.

The UAW supports the enactment of a plan solvency rule that will ensure that underfunded plans are able to pay promised benefits even as they improve their funded status.

In conclusion, Mr. Chairman, the UAW is firmly committed to improving the funding status of pension plans. We look forward to working with you and other members of the committee in the future as you consider this critically important matter.

Thank you.

[The prepared statement follows:]

STATEMENT OF WILLIAM S. HOFFMAN, PH.D.
DIRECTOR, UAW SOCIAL SECURITY DEPARTMENT

Mr. Chairman, my name is William S. Hoffman. I am director of the Social Security Department of the International Union, United Automobile, Aerospace, & Agricultural Implement Workers of America (UAW). The UAW represents 1.4 million active and retired members of the UAW, most of whom are covered by defined benefit pension plans. We thank you for the opportunity to testify on the subject of the proposed Retirement Protection Act of 1993 (H.R. 3396) and the problems associated with pension plans that are less than fully funded.

The UAW commends the Administration for its careful review of the financial status of pension funds and the Pension Benefit Guaranty Corporation (PBGC), and the security of the retirement income protection afforded American workers. We agree with the Administration that there is no immediate crisis facing the PBGC. At the same time, we also agree with the Administration that there are longer term concerns that can and should be resolved now.

The legislation which has been developed by the Administration, the proposed Retirement Protection Act of 1993 (H.R. 3396), focuses on strengthening the funding rules for pension plans. In our judgment, this is the best way to address the problem of "underfunded" pension plans. Improving the funded status of pensions directly improves the retirement income security of plan participants and also helps to protect the PBGC. The UAW applauds the Administration for taking this positive approach, rather than an approach which would cut benefit guarantees or restrict benefit increases.

The UAW strongly opposes proposals others have made to cut the PBGC benefit guarantees, such as by lengthening the phase-in period for the guarantees or eliminating the guarantee for plant closing benefits. And we also strenuously oppose proposals that would restrict benefit increases by encumbering corporate assets. Such proposals would penalize workers and retirees by reducing the security and adequacy of their retirement income. As a result, these proposals are at odds with the central goals of the Employee Retirement Income Security Act of 1974 (ERISA). In contrast, the solution advocated by the Administration - requiring quicker, more secure funding of pension plans - is fully consistent with the goals of ERISA.

The problem of "underfunding" in certain pension plans has not been caused by overly generous PBGC guarantees. Under current law, there are already limits on the amount of benefits which are guaranteed. More importantly, the five year phase-in of the guarantees provides adequate protection against so-called "deathbed" benefit increases shortly before a plan termination. Due to the five year phase-in of the guarantees, companies and unions cannot "conspire" to increase benefits and then dump the unfunded liabilities onto the PBGC. Thus, there is no need to change the existing PBGC benefit guarantees.

Similarly, the problem of "underfunding" has not been caused by inappropriate or excessive benefit increases. While the pension plans negotiated by the UAW with the Big Three auto companies are currently less than fully funded, over the last two decades the benefits provided by the plans have continued to replace a relatively constant percentage of pre-retirement income. The lifetime benefits for our longer service Big Three retirees have ranged around thirty percent of pre-retirement income. And, the total "thirty-and-out" benefit provided to early retirees not yet eligible for Social Security (which includes a temporary supplement, as well as a lifetime benefit) has typically replaced between 50 and 60 percent of pre-retirement earnings.

The reason there has been so much misunderstanding is due in large part, we believe, to confusion over the difference between salary related plans and flat dollar plans. Most pension plans, including the plans maintained by the Big Three auto companies for their management employees, provide pension benefits equal to a set percentage of the wages or salary of the plan participants. Thus, as salaries grow over time (due to inflation or real increases), the amount of pension benefits provided under these plans increase automatically. There is no need to amend the plans every few years to update the benefit levels. Due to the salary-related formulas which are used to calculate benefit levels, this happens automatically.

Unfortunately, the UAW has never been able to negotiate salary-related benefit formulas in plans which cover rank-and-file workers. Instead, these plans (including the plans maintained by the Big Three auto companies for UAW members) calculate benefits based on a flat dollar amount for each of the worker's years of service with the company. As a result, the pension benefits provided under these plans do not automatically rise with the growth in wages (due to inflation or real increases). Instead, the plans have to be amended every few years to adjust the benefit levels to keep pace with the growth in wages. Without these ad hoc increases, the real value of the

pension benefits gradually erodes over time, as they replace a lower and lower percentage of the pre-retirement earnings of workers.

Thus, the criticism which has been directed at the benefit increases negotiated by the UAW with the Big Three auto companies is unfair. These increases have not been excessive or irresponsible. They have simply updated the benefit levels to keep pace with the growth in wages, so that the real purchasing power of the pension benefits has not been eroded. These ad hoc benefit increases have simply accomplished the same result that happens automatically under management pension plans.

Proposals that would restrict ad hoc increases in flat dollar plans, such as requiring corporations to put up collateral for these increases, would discriminate against rank-and-file blue collar workers. In effect, blue collar workers would be condemned to a decreasing standard of living in retirement. It is worth noting that supporters of these proposals have never suggested that collateral requirements or other restrictions should be applied to the automatic benefit increases which occur under salary related plans covering management personnel. This amounts to a double standard, and underscores the unfairness of imposing such restrictions on ad hoc increases in flat dollar pension plans covering blue collar workers.

In addition to negotiating ad hoc increases that maintain the purchasing power of pension benefits for rank and file workers, in recent years the UAW has also been forced to negotiate special early retirement programs to assist in the downsizing of the Big Three auto companies. Again, these programs have not been excessive or irresponsible. It is widely recognized that pension plans play an essential role in responsible and humane efforts to downsize a workforce. Many other companies have instituted similar programs. Congress recently approved such a buyout program to help reduce the federal workforce. If the UAW had not negotiated these special early retirement programs at the Big Three auto companies, thousands of younger workers would have been laid off, resulting in untold human misery and dramatically increasing the costs to federal, state and local governments in unemployment and welfare benefits. The efforts of the Big Three auto companies to reorganize would have been severely hampered, thereby jeopardizing the jobs of the remaining workers. Thus, it clearly does not make sense to restrict or prohibit the types of special early retirement programs which have been negotiated by the UAW.

If the problem of "underfunding" in certain pension plans has not been caused by excessive or irresponsible benefit increases, and has not been caused by the PBGC guarantees, what is the culprit? The answer is really very simple. The inescapable truth is that these pension plans are not fully funded because the companies have not contributed sufficient monies to the plans. Thus, the obvious solution is for Congress to enact legislation requiring quicker, more secure funding of these plans.

There are a number of reasons why these pension plans have not been fully funded. Many of the companies which sponsor these "underfunded" plans have been experiencing severe financial difficulties as a result of the misguided trade and economic policies of the previous Administrations. As a result, they have not always been in a position to aggressively fund their pension plans. At the same time, as these companies have been forced to downsize, the ratio of retirees to active workers and the average age of the active workforce have both substantially increased. This has resulted in higher pension liabilities. Compounding these difficulties is the fact that many of these same companies also face enormous liabilities for retiree health care benefits - liabilities which place them at a disadvantage with foreign and domestic competitors.

The UAW is pleased that the Clinton Administration has taken steps to address these underlying problems. The economic and budget policies of the Administration have provided a basis for renewed economic growth. We are hopeful that the Administration's trade initiatives with Japan will alleviate our longstanding trade imbalance with that country, especially in the automotive sector. And the national health care reform plan developed by the Administration promises to provide health security to all Americans, while at the same time relieving the unfair competitive disadvantage currently suffered by the Big Three auto companies with respect to health care costs. The combination of all of these initiatives can play a powerful role in enabling the Big Three auto companies and other employers to provide better funding for their pension plans.

Contrary to the suggestions by some observers, there has never been any understanding between the UAW and the Big Three auto companies to leave our pension plans "underfunded". In order to establish the principle that pension plans should be pre-funded, rather than being operated on a pay-as-you-go basis, the UAW

struck Chrysler in 1950 for over 100 days. We strongly supported the enactment of ERISA's minimum funding standards in 1974. And we worked to tighten these funding standards in 1987 when the OBRA changes were enacted.

Recently, each of the Big Three auto companies has taken steps to contribute substantially more than the amounts required under ERISA. This past year Chrysler contributed over $2.0 billion to its pension plans for UAW members. During 1992, Ford contributed $1.4 billion to its UAW-hourly pension plan, and will contribute another $1.4 billion for the 1993 plan year. General Motors is presently moving to improve the funding of its pension plan. Its Board of Directors has approved an aggressive funding approach. We understand they will accelerate funding in order to make their plans fully funded by the year 2000. The UAW has welcomed these voluntary efforts to improve the funded status of our plans.

Nevertheless, the UAW believes there is still a need to enact changes in ERISA's minimum funding standards to require companies with "underfunded" pension plans to gradually improve the funded status of those plans over a reasonable period of time. Only through legislation can we be assured that necessary contributions will be made. That is why we are pleased the Administration has endorsed this approach in the Retirement Protection Act of 1993 (H.R. 3396).

The UAW supports a number of specific reforms to strengthen ERISA's funding rules and improve the funded status of pension plans. Specifically, we support tightening the Deficit Reduction Contribution required under OBRA '87 to assure that a plan's funded status actually improves. In this regard, we believe:

1. The double counting of gains and losses in the Funding Standard Account and in the Deficit Reduction Contribution calculations must be eliminated;

2. Actuarial assumptions and interest rates should be required to be responsive to standards that reflect actual plan performance and market conditions, so they cannot be used as tools to minimize required contributions;

3. The Deficit Reduction Contribution formula must also be strengthened in order to move plans more quickly toward a fully-funded position; and,

4. Plan sponsors should be required to recognize for funding purposes any benefit increases that have been negotiated, even if they have not yet become effective under a collective bargaining agreement.

The UAW also believes that some transition rules are needed to make sure that the tougher funding rules do not jeopardize the economic viability of some companies. We are pleased that the Administration has included a transition rule in H.R. 3396. But we are concerned about the application of the Administration's transition rule to future increases in pension liabilities. These increases may result from poor market performance, benefit increases or an unpredictable contingent event. Regardless of the reason for the increased liabilities, under the Administration's transition rule, these additional liabilities can lead to dramatic swings in the amount of contributions which a company is required to make from one year to another. This would make it more difficult for a company to meet its pension obligations, and could aggravate the company's financial difficulties.

The UAW believes that the strengthened funding rules should provide for a relatively stable and predictable funding requirement. This can be accomplished by permitting increases in current liabilities which occur in any year to be funded over three years; that is, to be phased in to the targeted funding percentage over three years. This will increase the funded status of the plan to the same position it would have reached over the three year period under the Administration's approach, but with a leveling of the contributions required in any given year as a result of the increased liability. Under the Administration's transition rule, based on historical patterns, certain UAW employers could face swings in required contributions of at least two-fold from year to year. In contrast, our proposal to allow three year funding of increased liabilities would reduce these dramatic fluctuations, without diminishing appreciably the movement of a plan to a more fully funded position.

The UAW also supports the enactment of a plan solvency rule that will assure that underfunded plans are able to pay promised benefits even as they improve their funded status. It makes sense to require a plan to maintain liquid assets equal to expected near-term benefits and other plan obligations.

The UAW strongly opposes the provision in the Administration's bill which would increase the variable rate premium by phasing out the cap. If enacted, this change

would place a substantial additional financial burden on companies. Instead of requiring companies with underfunded plans to pay additional premiums to the PBGC, the UAW believes it would be preferable to have these funds go into pension plans directly.

We understand that the Administration has proposed an increase in the variable rate premium in order to offset the "revenue loss" associated with the tougher funding rules and to make the overall bill revenue neutral. The UAW urges Congress not to let the arcane rules of budget scoring force bad policy. Either some other revenue source should be found, or the entire bill should be exempted from the normal budget rules. Since the tougher funding rules will help to protect the PBGC from additional unfunded pension liabilities, they should not be scored as revenue losers. The Administration should not be required to find revenue sources to offset these prudent funding proposals.

With respect to the other provisions in the Administration's bill, the UAW believes the PBGC should have advance notice of reportable events which could threaten a plan's funding or viability. We also support giving PBGC the authority to challenge corporate transactions which could undermine the adequacy of plan funding.

The PBGC has raised concerns over increases in benefits to participants while a corporation is in bankruptcy. The UAW believes it is unduly harsh to prohibit benefit increases in this situation. Current law protects the PBGC because these benefit increases are phased in over a period up to five years. Also, a total prohibition on benefit increases would deny increases to workers employed by healthy businesses, which find themselves in bankruptcy only because of the insolvency of a sister corporation. Finally, benefits in management pension plans that are salary related would be automatically increased if any pay raises are granted during the bankruptcy process. Thus, the proposal unfairly discriminates against blue collar workers whose benefits are typically provided through flat dollar plans.

We are in agreement that PBGC should have more timely access to financial information dealing with both plan sponsors themselves and their pension plans. The information should pertain to certain cases of severe plan underfunding, or cases involving significant amounts of missed or waived contributions. In addition, we believe that the PBGC should have authority to enforce minimum funding standards in PBGC-covered plans. We also support measures requiring plan sponsors to inform participants when a plan is "underfunded", and to advise them that there are limits to the guarantees provided by the PBGC. However, we are concerned that the implementation of the notice procedure should be handled carefully so as not to cause undue panic among covered participants.

There are two additional items not covered by the Administration's bill which the UAW believes should be addressed by Congress in any pension legislation. First, the PBGC has argued that the Pension Protection Act of 1987 curtailed the rights of participants and their representatives in recovering non-guaranteed benefits in the event of a plan termination. In at least one reported case, the PBGC prevailed in that argument and participants there were prevented from asserting contractual claims for non-guaranteed benefits. We believe Congress should clarify the right of plan participants and their representatives to assert claims for non-guaranteed benefits they often lose in many underfunded plan terminations.

Second, Title IV of ERISA requires the PBGC to guarantee pension benefits of defined benefit pension plans. Under a previous Administration, the PBGC took the position that when the liabilities for these benefits have been provided for by the purchase of annuities from an insurance company, the agency no longer is responsible for these benefits. The UAW believes this position is directly contrary to the intent of Congress when it enacted the Single Employer Pension Plan Amendments Act of 1986. If this erroneous interpretation by the PBGC is not corrected, the security of pensions, as required by Title IV, would be drastically eroded. We urge you to reassert the PBGC's role in guaranteeing pension benefits regardless of the institution that is paying the benefits to retirees and their surviving spouses.

In conclusion, Mr. Chairman, the UAW appreciates the opportunity to testify on the subject of the Retirement Protection Act of 1993 (H.R. 3396). We are firmly committed to the objective of improving the funded status of pension plans. We look forward to working with you and the other Members of this Committee as you consider this critically important issue. Thank you.

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Mr. PICKLE. Mr. Hoffmann, I can't say that this is a surprise, but this is real progress in the sense that you are recommending the legislation in principle that the administration has recommended, and I think that is significant, but I assume you are saying you oppose the cutting of benefits in any respect.

Mr. HOFFMAN. Right.

Mr. PICKLE. And I suppose that would include steps made to reduce your funding for the employee, the participant, and that you recommend we ought to have quicker funding.

Mr. HOFFMAN. Right. The real answer is to get more money into the plans as quickly as possible.

Mr. PICKLE. I think that is very important. Tell me, what is your position on flat benefit plans?

Mr. HOFFMAN. I am sorry. I am not sure—my position on flat benefit plans is——

Mr. PICKLE. Yes. Well, most of the negotiated plans nowadays really are what are called flat benefit plans. Do you all still prefer that?

Mr. HOFFMAN. Well, in a perfect world, we prefer a salary related plan. If we had enough resources available to start over, that would be the ideal.

In fact, what we attempt to do is to maintain a fairly constant replacement rate from preretirement earnings, so we approximate the benefit levels that could be provided on an income basis under a salary related plan. To do that, we need to do it with quicker funding.

Mr. PICKLE. I noticed that in your testimony you also made this statement, that you believe Congress should clarify the right of plan participants to assert claims for nonguaranteed benefits they often lose under the underfunded plans.

How would you do that?

Mr. HOFFMAN. I think if you clarify that the standing of individual participants and their representatives is not abrogated under the Pension Protection Act of 1987, then we would have the standing to file claims under contractual relationships with employers.

PBGC has asserted its claims and, in fact, has been upheld in at least one court case. We think that both participants and PBGC ought to be able to go after the corporations for their nonguaranteed benefit amounts.

Mr. PICKLE. Now, we will hear from the Pension Issues Coalition, Curtis Barnette, chairman of the Bethlehem Steel Corp.

Mr. Barnette.

STATEMENT OF CURTIS H. BARNETTE, CHAIRMAN, BETHLEHEM STEEL CORP., ON BEHALF OF PENSION ISSUES COALITION

Mr. BARNETTE. Mr. Chairman, thank you very much for this opportunity of testifying before you, and we wish to recognize your leadership and that of Chairman Rostenkowski on this very important issue.

This Coalition represents a broad cross section of American business. Our members sponsor pension plans covering nearly 2 million workers and retirees backed by some $90 billion in assets.

The Coalition has a vital interest in maintaining the financial integrity of the PBGC. Last year, Coalition members paid the PBGC $105 million in premiums, about 12 percent of its total.

We certainly support the administration's goal of ensuring a financially sound pension insurance program. Many of our members, my company included, and I have appeared recently twice before this committee to support, for example, the President's objectives in health care reform, and we certainly support responsible pension reform.

We believe that certain points in the administration's bill, such as the elimination of excise taxes on large pension contributions, would be very helpful, and there are other provisions as well.

Mr. PICKLE. That is good.

Mr. BARNETTE. We do however, believe that there are certain provisions, Mr. Chairman, we think respectfully may be counterproductive, and they have to do with impairing the competitiveness of our companies in a severely competitive international environment.

First, the administration's proposal would require members of the Coalition to fund pensions to a level that is above the amount necessary to pay the promised benefits. This is mainly because the proposal requires plans to calculate their liabilities using assumptions about mortality and interest rates that are essentially wrong for the members of our group.

Second, the proposed legislation would impose a premium increase. We believe there is no need for the increase. PBGC now collects $1 billion a year in premiums. Its annual expenditures to pay benefits are only one-third of these premiums.

Third, the Coalition is concerned with the provisions that would grant sweeping oversight and enforcement powers to PBGC. The bill would authorize a level of governance and interference in, we believe, arm's length business transactions that are not warranted.

Some have argued that a crisis is at hand, Congress must act. We were very pleased to hear Secretary Reich this morning. We agree there is no crisis. The financial condition of the PBGC we believe is not deteriorating, and it will certainly not become the next S&L crisis.

Let me respond on these points. First, the deficit, we think, is not really increasing. Since the mid-1980s, the total reported deficit has grown from $1.5 to $2.9 billion. In 1989, however, the PBGC began to count probable terminations as part of its current deficit. These terminations are pension plans that it believes will terminate in the future.

Because of this change, changes in accounting methods, it appears to be worse off. In fact, its deficit for actual terminations has decreased during this period.

Second, the Coalition has examined the trend in the funding level of pension plans themselves, and according to PBGC, pension plan underfunding has nearly doubled in the past 6 years to $53 billion. This increase is a result of the changes in the way PBGC calculates pension liabilities and the downward trend in interest rates.

Indeed, we believe that if the PBGC were to calculate plan funding levels using consistent accounting methods and a constant in-

terest rate, the funding levels, for example, on the top 50 list would show actual improvement.

Third, there are good reasons for improved pension funding. Since 1986, it has become very expensive for companies to maintain pension plans that are not fully funded. Companies must recognize pension liabilities on their balance sheets and their income statements. And, as we have heard, the SEC requirements make it very important that we fund these liabilities promptly.

In response to these changes, many members of the Coalition, Mr. Chairman, have taken rather extraordinary steps to deal with their pension liabilities, including my company. We have recently contributed the proceeds of two stock offerings, some $480 million to our plans. We have contributed $2 billion since 1988.

Westinghouse has announced its intention to contribute an additional $200 million in stock to its pension plan. Since the beginning of 1993, Chrysler has contributed more than $3.5 billion above the legal minimums to its pension plans.

The Coalition supports constructive reform. We do not believe there is a crisis. While there are many positive aspects to H.R. 3396, taken as a whole, we believe it might impair the competitiveness of our companies and as a result, the welfare of our employees and our retirees.

We want to continue to work with you and the administration and the Congress to bring about a sound and proper reform and we do thank you, Mr. Chairman, for this chance to appear before you.

Mr. PICKLE. Glad to have you here. Appreciate your testimony.

[The prepared statement follows:]

TESTIMONY OF CURTIS H. BARNETTE
CHAIRMAN, BETHLEHEM STEEL CORPORATION
ON BEHALF OF THE PENSION ISSUES COALITION
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
APRIL 19, 1994

Thank you, Mr. Chairman. I am Hank Barnette, Chairman of Bethlehem Steel Corporation. I am testifying today on behalf of the Pension Issues Coalition, a group of companies that was recently formed to work together on legislation to reform the Pension Benefit Guaranty Corporation. We appreciate the opportunity you have given us to testify on the Administration's proposed legislation, H.R. 3396, "The Retirement Protection Act of 1993."

The Pension Issues Coalition represents a broad cross section of American business in industries such as airlines, automobiles, defense, energy and metals. Coalition members operate in highly competitive markets, often with intense foreign competition. Members companies include ALCOA, Armco, Bethlehem Steel Corporation, Chrysler Corporation, Ford Motor Company, General Motors Corporation, Northwest Airlines, Inc. and Westinghouse Electric Corporation. Coalition members sponsor pension plans covering nearly 2 million workers and retirees, backed by over $90 billion in assets.

The Coalition has a vital interest in maintaining the financial integrity of the PBGC. As the Committee well knows, the PBGC is not supported by taxpayers; PBGC is supported by premium payers. Last year, Coalition members paid PBGC $105 million in premiums, about 12 percent of PBGC's total.

The Coalition has only recently been formed and, therefore, has not reviewed alternatives to the Administration's proposal and has yet to take a final position on the need for PBGC legislation. The Coalition will continue to share its views with Congress as we review these issues in more detail. The Coalition applauds the Administration's goal of ensuring a financially sound pension insurance program, and its willingness to listen to a wide range of views concerning the PBGC. We also applaud the Administration's concerted efforts to tone down the rhetoric used to bolster claims that reform is urgently needed. Many members of the Coalition, my company included, have been supportive of the Administration's legislative efforts in other areas, including health care reform. And, we believe that certain points in the Administration's bill -- such as the elimination of excise taxes on certain large pension contributions -- would be helpful. However, there are other provisions in the proposed legislation that we believe would impose unwarranted additional costs and impair our ability to compete internationally. Let me give you some examples.

First, the Administration's proposal would require members of our Coalition to fund pensions to a level that is <u>above</u> the amount necessary to pay all promised benefits. This is mainly because the proposal requires plans to calculate their liabilities using assumptions about mortality and interest rates that are wrong for the members of our group. A recent, detailed study by the Society of Actuaries independently confirms that the mortality table mandated by H.R. 3396 does not reflect the actual experience of companies such as ours. By requiring employers to use actuarial assumptions that overstate pension liabilities, the proposal imposes excessive funding costs on employers.

Not only is full-funding redefined by H.R. 3396, but companies are required to reach this new level very rapidly. The result is large increases in annual contributions that apply retroactively to benefits that have already been bargained. Capital-intensive businesses faced with intense

competition, much of it foreign, will be less able to weather business cycles and make the capital investments necessary to stay competitive. Weaker companies mean fewer jobs. Equally important, weaker companies mean greater risks to the PBGC.

Second, in addition to the new funding requirements, the proposed legislation would impose a premium increase. There is no need for this increase. The PBGC premium has been raised three times -- ten-fold -- in the last decade. For Coalition members, the average increase has been greater. PBGC premium revenues are now close to $1 billion annually. But, PBGC's annual premiums are three times PBGC's cash expenditures to pay unfunded guaranteed benefits. This very healthy cash flow stands in sharp contrast to the mid-1980s, when the PBGC's annual premiums did not cover PBGC's share of annual benefits.

The main reason -- perhaps the only reason -- for the proposed premium increase is the need to make the bill "revenue neutral," that is, to offset the additional tax-deductions that would result from the increased pension funding required by the bill. The members of the Coalition disagree with this logic. The new funding requirements included in H.R. 3396 are supposed to reduce the risk to the PBGC. But, if this were true, PBGC would need less premium revenue, not more.

Third, the Coalition is also concerned with the provisions of H.R. 3396 that would grant sweeping new oversight and enforcement powers to the PBGC to interfere in the ordinary transactions of companies that sponsor so-called "underfunded" pension plans -- determined using PBGC's overly conservative measures. The bill would authorize a level of interference in arm's length business transactions that is simply not warranted. Ironically, this interference would be aimed at the companies that have the greatest need to restructure in order to remain competitive.

Some have argued that a crisis is at hand and Congress must act regardless of these problems. We do not believe there is a crisis. The financial condition of the PBGC is not deteriorating and PBGC will not become the next "S&L" crisis.

Let me elaborate on these important points.

The PBGC's deficit is not increasing. Since the mid-1980s, PBGC's total reported deficit has grown from $1.5 to $2.9 billion. During that time, however, PBGC changed its accounting methods. In 1989, the PBGC began to count "probable" terminations as part of its current deficit. Probable terminations are pension plans that the PBGC believes will terminate, but have yet to actually terminate. This change in accounting methods does not reflect any underlying change in PBGC's financial condition. But, because of the change, PBGC appears to be worse off. In fact, PBGC's deficit for <u>actual</u> terminations has <u>decreased</u> during this time. Given the dramatic decline in interest rates over the last few years -- a decline that tends to increase PBGC's calculated deficit and individual companies' calculated liabilities -- it is a very encouraging sign that the PBGC deficit has not risen sharply. The PBGC has also changed its mortality assumptions twice, and both times the result was an increase in measured but not actual liabilities. When PBGC's deficit is computed the same way each year using the same assumptions and accounting conventions, the only conclusion that can be drawn from the recent history of PBGC is not that something is going wrong, but rather that something is going right.

Another cause for concern about the PBGC has been gloomy projections about the PBGC's future deficit. The conventional wisdom -- supported by the most pessimistic projection in PBGC's 1992 Annual Report -- appears to be that the PBGC will have a deficit of over $20 billion by the turn of the century. But that projection is highly speculative. It assumes that PBGC will suffer annual losses about equal to the sum of all the losses the agency incurred in the first 16 years of its existence. Moreover, it assumes that benefits (the guaranteed maximum) and PBGC administrative expenses will continue to grow while premiums will never increase. Projections that assume that a program's liabilities will grow but revenues will not, will inevitably show growing deficits.

PBGC itself publishes a "mid-level" projection that assumes losses based on the recent history of the agency. If this mid-level projection included an assumption that premiums increased with inflation, there would be no projected deficit at all. Unfortunately, too often only speculative, "worst-case" scenarios receive any attention.

The Coalition has also examined the trend in the funding level of pension plans themselves that was described in the press release announcing this hearing. According to PBGC, pension plan underfunding has nearly doubled over the past six years to $53 billion. But, upon closer examination, what emerges is a picture not of growing unfunded liabilities, but a picture of concerted efforts to improve the funded status of pension plans. This progress has been obscured by changes in the way PBGC calculates pension liabilities and the downward trend in interest rates. The Coalition believes that if PBGC calculated plan funding levels using consistent accounting methods and a constant interest rate, the funded status of plans on the "Top 50 List" published by PBGC would have actually improved since the agency began publishing the list.

The substantial efforts reflect a commitment to funding pension promises and are also the result of significant changes in the legal and accounting environment that have gone largely unrecognized in the debate over PBGC reform. Since 1986, it has become much more expensive for companies to maintain pension plans that are not fully funded. Companies are now required to recognize unfunded obligations on both their balance sheets and their income statements. As a result, unfunded pension liability reduces stockholder equity and earnings per share. Another important change has been the reaction of creditors to companies with pension underfunding. Creditors and the rating agencies now treat pension liabilities like any other debt. In general, companies with unfunded pension liabilities receive lower credit ratings and must pay more to borrow. Heightened creditor concern is no doubt due to new laws that this committee was instrumental in enacting in 1986 and 1987. The PBGC is now a creditor for the full amount of underfunding and creditors are learning the impact of this change in bankruptcy court.

In response to these changes, many members of the Coalition are taking extraordinary steps to fund their pensions. For example:

- Two recent stock offerings by my company, Bethlehem Steel, have resulted in an additional $480 million dollars being contributed to our plans.

- Westinghouse has announced its intention to contribute an additional $200 million in stock to its pension plan.

- Since the beginning of 1993, Chrysler has contributed more than $3.5 billion above the legal minimums to its pension plans.

The Pension Issues Coalition supports constructive reform of the PBGC. For example, the Administration's proposal to eliminate the excise tax that is now imposed on contributions in excess of 25% of compensation is a positive step. This would remove a significant impediment to even greater efforts to fund pension obligations. Even so, while there are some positive aspects to H.R. 3396, the members of the Coalition believe that H.R. 3396, taken as a whole, would impair the competitiveness of our companies and the welfare of our employees and retirees.

Thank you, Mr. Chairman. I would be pleased to answer any questions.

STATEMENT OF MICHAEL J. GULOTTA, CHAIRMAN, PENSION SUBCOMMITTEE, FINANCIAL EXECUTIVES INSTITUTE, COMMITTEE ON EMPLOYEE BENEFITS; AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, AT&T-ACTUARIAL SCIENCES ASSOCIATES, INC., SOMERSET, N.J.

Mr. PICKLE. Now, Mr. Gulotta.

Mr. GULOTTA. Good afternoon. My name is Michael Gulotta. I am president and CEO of Actuarial Sciences Associates, a subsidiary of AT&T, and I am appearing before you today in my capacity as chairman of the Pension Subcommittee of the Financial Executives Institute's Committee on Employee Benefits.

I would like to thank you for allowing us the opportunity to provide our views on reforming the pension guarantee program. We particularly wish to express our appreciation to this committee and to you, Mr. Pickle, for taking a leadership role on these issues.

Mr. PICKLE. Thank you.

Mr. GULOTTA. Further, we commend the Clinton administration, and in particular the PBGC and its Executive Director, Martin Slate, for addressing these issues now.

Our committee believes that promises made should be promises kept. This concept must be the cornerstone of any discussion of pension reform. Any change in pension law must provide for strengthening the pension plan funding and the maintenance of a strong safety net through the PBGC.

Most companies, in fact the vast majority of them, are keeping their pension promises. But while recognizing the overall health of the majority of plans, we should also recognize that there are problems in some plans.

We can antiseptically talk about increasing PBGC deficits or rising amounts of underfunding, but we must not forget the human effect of the few underfunded plans that do terminate. It is for the participants in these plans that we must strengthen weak plans. It is for the participants in these plans that we must ensure the continued presence of a strong and sound safety net.

But it is also important to recognize that there are two sides to the making and keeping of promises. Companies must not promise benefits they cannot pay for. But, if through reform legislation, we excessively speed up funding and overstate liabilities and thereby overprice pensions, we can hurt the economic future of both the companies and the plan participants.

You could take a position that companies should not ever grant the benefit improvement until they already have the cash on hand to pay for the benefits. That is like saying someone shouldn't buy a car unless they have the dollars in hand to pay for that car. But in these extreme cases, we would have neither cars nor pensions.

I am not suggesting that the proposed legislation is extreme. Indeed, it is directionally correct, but it is somewhat aggressive in solving a problem which has evolved over decades. We can't solve it in only a short period of time.

Our committee has established the following 10 principles for PBGC reform: One, funding should be accelerated for new amendments to underfunded plans. And guarantees for these increased benefits should accrue over a timeframe that is similar to the funding period.

Two, changes in funding rules should be primarily prospective. Three, funding rules must balance the risk of cash flow volatility against the need for increased funding. Four, to encourage funding, employers' abilities to make tax favored pension contributions should be increased, reversing the recent trends to reduce or limit the deductibility of employer contributions.

Five, shutdown benefits or contingent benefits, should be reimbursed to the pension plan as soon as possible. Six, contributions should be increased to reduce current liability underfunding in a manner that addresses the problems caused by double counting of gains and losses, and in a manner that removes the possibilities for abuse.

Seven, the current open-ended PBGC guarantee needs to provide appropriate limitations and exclusions. Eight, prepetition and postpetition required contributions should be given priority status in bankruptcy. Nine, premium increases should not be considered as a solution, and last, ten, actuarial assumptions should not be rigidly mandated in statute, but they should continue to reflect individual plan circumstances.

We are in agreement with many of the goals of the administration proposal. We agree that funding must be increased in underfunded plans. We agree that better opportunities must be made available to underfunded plans that have the money to fund up. We agree that companies should not be able to avoid pension contributions during bankruptcy and that shutdown benefits should not be allowed to drain a pension plan's assets.

However, in some instances, we do differ on the appropriate ways to achieve these goals. We prefer to emphasize prospective changes and decrease short-term volatility. We are concerned that volatility in cash flow will jeopardize long-term commitment of sponsors to maintain defined-benefit plans.

We believe that the primary focus of reform should be on new benefit promises and that the discussion of reform should center on funding and guarantees for new benefits being promised. Furthermore, we strongly oppose the premium increase, the mandating of assumptions, the proposed reduction in 415 limits and the intrusion of PBGC into sensitive mergers and acquisitions' negotiations.

We appreciate the opportunity to share our views with you. We look forward to working with you in insuring the passage of meaningful and appropriate reform legislation. That legislation is needed.

Mr. PICKLE. Well, I thank you, Mr. Gulotta.

[The prepared statement follows:]

Testimony of
Michael J. Gulotta
President and Chief Executive Officer
Actuarial Sciences Associates, Inc. a subsidiary of AT&T

on behalf of

Financial Executives Institute - Committee on Employee Benefits

Good afternoon. Chairman Rostenkowski and Members of the Ways and Means Committee, I am Michael J. Gulotta, President and Chief Executive Officer of AT&T-Actuarial Sciences Associates, Inc. appearing before you today in my capacity as Chairman of the Pension Subcommittee of FEI's Committee on Employee Benefits. I would like to thank you for allowing us the opportunity to provide our views on reforming the pension guarantee program.

CEB is the policy-making body for FEI on benefits issues. CEB's members represent a broad cross section of financial executives from mid-sized to Fortune 50 companies that administer over $225 billion in defined benefit pension plan assets. The Committee's members also represent a range of plans, from plans in full funding to plans reporting assets less than accrued liabilities. Nine members are from companies that reported qualified plans with assets less than liabilities in their most recent financial statements -- including some of the companies with the largest PBGC underfunding.

CEB believes that there are important issues that should be addressed in the pension reform area. We think these issues should be addressed now, when reform can be primarily prospective; the problems here cannot be left to accumulate until they reach a crisis. CEB particularly wishes to express its appreciation to this Committee for taking a leadership role on these issues. Further we commend the Clinton Administration and in particular the PBGC and its Executive Director, Martin Slate, for addressing these issues now.

Keeping Promises

Promises made should be promises kept. CEB believes that this must be the cornerstone of any discussion of pension reform. Any change in pension laws must provide for the strengthening of pension plan funding and the maintenance of a strong safety net through the PBGC.

Most employers, in fact the vast majority of employers, are keeping their pension promises. The overall level of assets in private defined benefit plans continues to exceed the overall level of liabilities, even when measured very conservatively. PBGC's estimate of underfunding in private plans represents only a small fraction of private plan assets or liabilities.

But, while recognizing the overall health of the majority of plans, we should also recognize that there are problems in some plans. We can antiseptically talk of increasing PBGC deficits, or rising amounts of underfunding, but we must not forget the human effect of the few underfunded plans that terminate. It is for the participants in these plans that we must strengthen weak plans; it is for the participants in these plans that we must ensure the continued presence of a strong and sound safety net.

But it is also important to recognize that there are two sides to the making and keeping of promises. Companies must not promise benefits that they cannot pay for. But if -- through reform legislation -- we excessively speed up funding and overstate liabilities thereby overpricing pensions, we can hurt the economic future of both companies and plan participants. You could take a position that companies should not ever grant a benefit improvement until they already have the cash on hand to pay for the benefits -- that's like saying that a person should never purchase a car until they have saved the whole amount of the purchase price. But, that ignores the net added value to both parties of taking on a commitment that can be funded over a reasonable period related to when the car's (or the pension's) purchase price can be earned.

Principles for Reform

The remainder of my comments are addressed primarily to the provisions of the Retirement Protection Act of 1993 (H.R.3396/S.1780), on reforming the pension system. In reviewing the legislation, CEB has established the following set of principles for PBGC reform:

- Funding should be accelerated for new amendments to underfunded plans. Guarantees for these increased benefits should accrue over a time frame that is similar to the funding period.

- Changes in funding rules should be primarily prospective.

- Funding rules must balance volatility against the need for increased funding.

- To encourage funding, employers' ability to make tax-favored pension contributions should be increased, reversing recent trends to reduce or limit the deductibility of employer contributions.

- Shut down benefits should be reimbursed to the pension plan as soon as possible.

- Contributions should be increased to reduce current liability underfunding in a manner that addresses the problems caused by double counting of gains and losses and removes possibilities for abuse.

- The current open-ended PBGC guaranty needs to provide appropriate limitations and exclusions.

- Pre-petition and post-petition required contributions should be given priority status in bankruptcy.

- Premium increases should not be considered as a solution.

- Actuarial assumptions should not be rigidly mandated in statute, but should continue to reflect individual plan circumstances.

We are in agreement with many of the goals of the Administration proposal. We agree that funding must be increased in underfunded plans; that better opportunities must be made available to underfunded plans that have the money to "fund up"; that companies should not be able to avoid pension contributions during bankruptcy; that shut down benefits should not be allowed to drain a pension plan's assets. However, we do, in some instances differ on the appropriate ways to achieve these goals. Furthermore, we strongly oppose the premium increase, the proposed reduction in 415 limits, and the intrusion of the PBGC into sensitive merger and acquisition negotiations.

Our most significant areas of concern are funding, guarantees, premium increases and notice requirements.

Funding Requirements

CEB is concerned that certain provisions in the Administration's proposal could increase short term volatility in cash flow, jeopardizing the long term commitment of sponsors to maintain defined benefit plans. It is important that plan sponsors meet benefit commitments -- it is also important that pension benefits are not made unduly unattractive to companies, because then pension benefits won't be given to participants.

Overall, we would prefer to take a different approach to PBGC reform, which emphasizes prospective changes and decreased short term volatility.

First, we would like to see changes to funding rules made primarily on a prospective basis. The system is not in crisis; changes made now have time to work. Companies have planned for capital needs on the basis of current law. If you take an approach to funding reform similar to that taken by the Administration, it is important to eliminate paper games that double count gains and so reduce contributions, but on a prospective basis. This prospective application is primarily a transition rule, since double counting of gains and losses will wear off rapidly over the next 4 to 7 years.

Second, the Administration proposal focuses on parts of current law that determine contributions as a percentage of unfunded current liabilities, *instead* of the long term view. This focus does not distinguish between items under the sponsor's control -- such as new benefit promises -- and short term gains and losses. There can be significant annual fluctuations in the unfunded current liability value that are *not* significant in the long term view of plan funding. CEB believes that the appropriate focus should be primarily on new benefit promises. If the Administration approach is to be followed, caps on contribution volatility must be adopted that minimize short term fluctuations in cash flow due to items not under the sponsor's control.

More importantly, a focus on new benefit promises centers the discussion on the key question -- how can we ensure that promises are kept without overpricing the cost of pension promises, and thereby reducing the long term value of both companies and pension plan benefits? We must also ensure that the PBGC is not put at additional risk. Under current law there is a moral hazard inherent in allowing plan sponsors to grant benefits which are guaranteed by the PBGC in 5 years but funded over 30 years. This hazard to the PBGC must be eliminated. We also believe that the period over which guarantees accrue should be linked to a reasonable period in which to fund the plan.

CEB opposes the Administration proposal to specify mortality assumptions and reduce the range of current liability interest rates. Mortality should represent the actuary's best estimate of the actual experience of the plan population, not a standard that is based on an entirely different population group. In combination, the Administration interest and mortality proposal could significantly overstate the liability of the plan at termination, causing mature plans with sufficient assets to continue to make unneeded contributions.

CEB opposes the proposal's curtailment of funding opportunities for plan sponsors that is achieved by reductions in 415 limits. We believe sponsors need greater opportunities to fund pension programs. There are other more appropriate ways to raise needed revenue -- such as simplification and extension of the ability of plan sponsors with excess assets to use those assets to provide other employee benefits.

There are also items in the bill we strongly support. The Administration proposal would carefully preserve the ability of plan sponsors to prepay required contributions. We believe that this type of provision is imperative in any reform; plan sponsors must be given the opportunity to prepay contributions in good times, so that the money will be available to the pension plan in bad times.

The Administration proposal also helps sponsors of plans with assets less than 100% of current liability to "fund up" their plans to the 100% level. The measures in the proposal remove an excise tax that can apply to sponsors that maintain both a savings plan and an (underfunded) pension plan. This is a step in the right direction, but the proposal needs to further provide that the contribution to the savings plan is deductible.

PBGC Guaranty

CEB believes that the PBGC should continue to operate a safety net for participants. However, the current open-ended PBGC guaranty needs to provide appropriate limitations and exclusions. Of course, any limitations on PBGC's guaranty of prefunded benefits should be prospective. Primarily, our concern is that funding should be linked more closely to guarantees. We oppose provisions in the proposal that would increase guarantees for some partial owners of companies that sponsor pension

plans, decreasing the linkage with funding and increasing moral hazard. We also believe that contingent benefits that increase or cause underfunding, but are not advance funded (e.g., shutdown benefits), should not be guaranteed.

Premium Tax Increases

The Administration proposal would remove the cap on the variable rate PBGC premium. CEB does not support an increase in PBGC premiums. Given reform, PBGC's revenue needs should decrease, not increase.

Overall, CEB is opposed to increases in PBGC premium for general revenue collections. The primary destination of additional moneys attributable to a company's underfunded plan should be the plan itself. Any increases in PBGC premium must be directly linked to an evaluation of the PBGC's long term assets and liabilities.

Notice to Participants

CEB recognizes that there is a need to better inform participants about PBGC guarantees and the extent of unfunded benefits *before* a plan termination that results in loss of pension benefits. However, we cannot accept the Clinton Administration disclosure proposal, which would be triggered on the basis of unreasonable assumptions in a format as yet unknown. We would like to work with the Administration and the Congress to come up with a workable method for providing this information that is based on commonly available and accessible information, such as the disclosure of vested and accrued benefit obligations that are required under FAS87 (and monitored by the SEC).

PBGC Role in Mergers and Acquisitions

The proposal would intrude the PBGC into the sensitive arena of merger and acquisition negotiations. We believe that it is inappropriate to provide this authority to the PBGC. Under current law PBGC already has sufficient authority to pursue abusive transactions.

Conclusion

FEI appreciates the opportunity to share our views with you. We look forward to working with you in ensuring the passage of meaningful and appropriate PBGC reform legislation.

Mr. PICKLE. I want to assure you that we are not just trying to speed up the pension fund contributions at a rate that would cause damage to the company.

This is the part we have been looking at and concerned about for some years. It has been 10, 11 years since we passed the 1987 law—I mean 6 or 7 years. We had no way to know really how those laws would be carried out.

We think there are some very definite flaws with respect to mortality tables, interest rates and cross testing and the double counting of asset gains that is allowed. So we think changes definitely ought to be made. It is not something we just decided overnight; we are going to stick it to.

We are just simply saying that the plans ought to be funded, and in asking that they be funded, we just simply ask you to carry out the law, and that is really the essence of it. That is what I think the Secretary was testifying this morning.

Now, Mr. Barnette you stated in your testimony that you oppose removing the current $53 variable cap on premium payments, and I want to ask you, you are talking now from Bethlehem Steel, why do you think it is fair for companies in your organization to pay a variable rate premium which is substantially less than the $9 per $1,000 payment of plan underfunded charged to other companies whose plans are maybe even better funded than yours?

Why would you have to pay only an effective rate of $5 instead of the $53?

Mr. BARNETTE. I think we are paying a higher rate now, Mr. Chairman. We are paying about a $72 rate. Under the administration's bill, our benefit premium rate would go up to about $200.

I guess I return to the original point made in my testimony though that the premium that we have now, as we understand it, would more than compensate the corporation for the actual benefits that it must pay.

Mr. PICKLE. All the bill is recommending that they just remove the cap and then you actually then pay for the risk that your company poses to the taxpayers and on PBGC. Now, you object to removing the cap.

I assume you want to keep the cap like it is.

Mr. BARNETTE. Yes, sir.

Mr. PICKLE. And I assume that represents all the companies, and I am not surprised you would want to do that, but if we did that, the effective rate of your payment would not be $9 per $1,000 of underfunding, it would be much less than that, and so you have to ask yourself, where is the fairness of that. Now, I appreciate your testimony.

The Secretary of Labor, though, and Treasury, in many points that you have made today have said that they do not agree with you and that we ought to make these changes.

Now, they did say that there is no crisis, and this subcommittee and our full committee, I think, recognizes the same thing, that we ought not get excited about it, rush off here and do something rash. But, the administration has crafted a bill that they say is balanced, and I think basically that it is balanced.

Now, we have tried to take into consideration some of the things like eliminating the excise taxes. I think those are good changes,

and you have said that. I am not surprised though that the Coalition would differ on these points and say we don't need to make these changes, but there is a very definite difference of opinion on it.

Mr. Hoffmann, did you want to say something?

Mr. HOFFMAN. Yes. While I think there may be variations on the amount per $1,000, we think that the caps should remain also. We think that, in fact, the risk that is being insured is taken care of, and the best way to deal with it is in fact not to burden those companies least likely to be able to afford it when we want them to put the money into the fund, which has the effect, Mr. Chairman, of decreasing the liability, therefore the risk on PBGC, and particularly since PBGC is in a position to pay cash benefits as they are due and payable now.

So we would agree that the cap should remain, and that is one of the areas where we disagree with the administration's bill, one of the few.

Mr. PICKLE. We could be accused, as Mr. Barnette said, of doing it only for revenue, that we wanted the revenue for the PBGC. That is why it is being recommended.

Mr. HOFFMAN. Actually, sir, I want to make sure, my understanding is that PBGC does not need the cash at present or in the short term. It is a——

Mr. PICKLE. But they said——

Mr. HOFFMAN [continuing]. Revenue neutral.

Mr. PICKLE. They said that, but they said in the long-term if you don't make these changes now, the situation will get worse and worse. Therefore they say it is best to make these changes now. And I agree with them on that.

Mr. HOFFMAN. I don't mean to get into an argument. I think actually we are moving along in the same direction on this. Because in fact what they are talking about is the quicker funding reduces their long-term liability, and I think it is a revenue neutrality issue rather than the need for——

Mr. PICKLE. The Chair is going to recognize Mr. Kleczka.

Mr. Kleczka.

Mr. KLECZKA. I just have a short question, Mr. Chairman, knowing that we have to recess for three votes, but I do want to go back and question the CPAs coming out against the cross-testing provision.

Mr. Coustan, do you want to respond to my concern that if we permit cross testing, which is a growing new plan out in the marketplace, that we really don't resolve the discrimination problem, and we are opening up a rather large tax benefit in addition to a pension benefit for a certain number of people in our country.

Could you respond?

Mr. COUSTAN. Let me say a few words, and then I will ask Ms. Walker to say something additional, but over—the cross testing, first of all, was only one element of a very complicated and complex and long series of regulations that were promulgated by the Internal Revenue Service in the not too distant past.

We believe if you are going to remove cross testing, it is like just taking one piece of one link out of a very important chain, that the

whole chain ought to be examined with the possibility of strengthening that entire chain.

Second, the examples that Mr. Samuels gave this morning were anecdotal. I believe that you can find egregious examples, of course, but I don't think that those egregious examples are sufficient to toss out something which is proven to be a stimulus to the adoption of defined-contribution plans.

Mr. KLECZKA. Stimulus to the entire populous or to a select few?

Mr. COUSTAN. I think to those who wanted to provide to employees by using a defined-contribution plan, and I don't think that includes just a select few, in all due respect, sir.

I also believe, if you look at it very carefully, that over an employee's life, each employee is treated exactly the same over his working life, and cross testing ultimately, although it may favor, so to speak, older employees—it will always favor those employees, and as employees mature and become older, they will be the ones that receive the benefits. It is not just the owners that receive those benefits, but it is the rank and file also.

And so you have to look at an employee from the beginning of his employment until the end of his employment and over that lifetime, his employment lifetime, he will be treated equally with all the employees in the plan.

Mr. KLECZKA. Why do you contend that if it is eliminated, these companies will then dissolve their pension plans?

Mr. COUSTAN. Well, our experience indicates that that is what will happen. The expense, particularly with the limits that were put in place last year, 1993, just make it very expensive for people to continue these kinds of plans without being able to provide the kind of benefits that result in a cross testing environment.

Mr. KLECZKA. So they are going to punish the senior partners at the expense of the junior and the newly hired? I don't see that happening.

Mr. COUSTAN. Well, we believe that that will happen, and—I mean, neither one of us can prove what will ultimately result. Obviously these are forecasts, but I do believe that that can happen.

Deborah.

Ms. WALKER. Let me just reiterate that somebody has a decision of whether or not to have a pension plan and in many cases I firmly believe that people—there will be plans that will terminate because there can't be cross testing.

That is not to say that perhaps there are situations where there are abuses, but I think Congress, with all due respect, should be very careful that they are not trying to kill an ant with a sledgehammer here, and Assistant Secretary Samuels said that Treasury is willing to work with Congress, and I think perhaps that there might be some limits you could put on cross testing as opposed to just outright eliminating cross testing.

The experience I have had is that there are plans that are cross-tested plans, and there would be no plan at all for the rank and file if it weren't for cross testing.

Mr. KLECZKA. I just see some real discrimination here and you really haven't made the case to eliminate this from the bill.

Thank you, Mr. Chairman.

Mr. PICKLE. I want to add, we only have a few minutes to vote, Mr. Kleczka, we have got to leave and go to the next panel.

I want to say about discrimination, the Treasury has recommended these changes on cross testing. I don't believe anybody disagrees with preventing discrimination. Always the plans of the high-salaried executives are funded. They always seem to be in good shape.

If I were the union people, I think I would start asking my questions, do I want to continue this flat rate premium type negotiation.

I don't want to keep it on, but they do, maybe because they want to come back to it every year, two or three, but for whatever reason, they do it. What we can do if we make this legislation effective, pass it, we get money into these funds, and then the blue collar worker or the average worker will be covered.

It is a complex problem, but I don't say that we can just automatically say that cross testing should not be allowed. We make these changes because I think the Treasury made a sound proposal, but I think we ought to take another good look at it.

We are going to have to take a recess because we have got this and two other votes pending, so it will be about 20, 25 minutes before we can return.

[Recess.]

Mr. PICKLE. Ask the committee to please come to order again. We will go to our next panel, and that one consists of the ERISA Industry Committee, represented by Chester Labedz, the Association of Private Pension Plans with James Durfee, Small Business Council of America, Paula Calimafde, and the Women's Pension Policy Consortium, Vicki Gottlich.

They will all come forward with the panel. The first witness we will hear from is representing the ERISA Industry, Chester Labedz, and then we will go down the line, Mr. Durfee, Paula Calimafde.

Ms. CALIMAFDE. You are saying it right, Calimafde.

Mr. PICKLE. And then Vicki Gottlich. First Mr. Labedz.

I am going to ask each one of you to submit your testimony within the 5-minute period because we got this panel and another, and we have got another meeting that is going to take place at 3.

So we will have to move along as quickly as we can. I am sorry for this long delay, but it is one of those kinds of hearings.

STATEMENT OF CHESTER S. LABEDZ, JR., CHAIRMAN, TITLE IV TASK FORCE, THE ERISA INDUSTRY COMMITTEE; AND VICE PRESIDENT, HUMAN RESOURCES, TEXTRON DEFENSE SYSTEMS, WILMINGTON, MASS.

Mr. LABEDZ. I am pleased to appear this afternoon on behalf of the ERISA Industry Committee.

Let me say first and foremost that ERIC's members support a strong and defined-benefit system. I think you know that. We represent the Nation's largest employers. Virtually all of them have defined-benefit plans that together have millions of participants and beneficiaries. They are the PBGC's largest taxpayers.

As you know, ERIC has strongly supported, and we continue to support, strong and appropriate funding standards and a sound

and sensible termination insurance program. We support proper pension reform now in 1994.

As you know, we proposed legislation in mid-1993 that we feel addresses the root causes of pension funding problems. I ask permission to include it and related proposals in the permanent record.

Mr. PICKLE. What length is that insertion you want to put in? Is it like a report?

Mr. LABEDZ. I am sorry.

Mr. PICKLE. Did you ask for permission to include it in the record?

Mr. LABEDZ. Yes.

Mr. PICKLE. I have no objection if it is not a book.

Mr. LABEDZ. It is not a book.

Mr. PICKLE. Go ahead. It will be included.

Mr. LABEDZ. Thank you. Our proposal has the support of the employers who pay millions of dollars in benefits. Our proposal demonstrates their commitment to invest millions of dollars more and to invest it wisely.

We feel, however, that, although it is well intended, H.R. 3396 is fundamentally flawed, and that is because it addresses symptoms, not causes of problems. It also emphasizes the PBGC's interests over sound long-term pension funding.

What we need to do in the 1994 pension law is to encourage employers to make pension promises they can keep and to keep those promises that they have made. We need to take away the blank check for pension promises that can't be kept, but instead are picked up by the PBGC and by other employers. We need to discourage irresponsive bargaining of pension increases by both employers and unions, and we need to put additional employer funds into pension trusts, not into PBGC premiums.

What we don't need in the 1994 pension law are excessive funding standards that threaten a sponsor's prospects of future funding. Nor do we need retroactive funding changes that change the commitment many years after the fact. We don't need volatile, unpredictable pension funding. We don't need deductibility limits that discourage additional funding of plans that need that funding. We don't need the potential diversion of new premium funding into higher PBGC premiums, and we don't need the PBGC meddling in virtually every purchase or sale of a business and most joint ventures.

I will now provide a brief side-by-side comparison of key features of H.R. 3396 and ERIC's proposal from last May. First, on the blanket check issue: We know that your Oversight Subcommittee focused on this issue as critical too. We have attempted to solve it in a different way than you have. It is an important issue.

ERIC would link the guarantee to the anticipated funding schedule. We would phase in that guarantee in tandem with the funding schedule for future amendments. The simple rule going forward would be that no funding ought to mean no guarantee. We would eliminate the $20 minimum.

H.R. 3396 does not fix this problem. Instead, it expands it by expanding the guarantee to disability benefits as well. It provides a

system in which increases can be granted or negotiated and guaranteed fast, even if the plans are woefully underfunded.

In the funding area, ERIC focuses on strong basic funding standards for future amendments, not merely the deficit reduction contribution. Again, we feel that H.R. 3396 provides an "after-the-fact" treatment for plans that have gotten into trouble as opposed to a remedy up front.

We would also amend the tax deduction limits to get at the core of the issue, which is deductibility. H.R. 3396 does not go far enough because it merely addresses the excise tax.

In summary, we feel that ERIC's bill is appropriate legislation. It addresses the root causes of pension problems more directly than does H.R. 3396.

We thank you for the opportunity to testify and stand ready to answer any questions.

Mr. PICKLE. Thank you, Mr. Labedz.

[The prepared statement and attachments follow:]

STATEMENT OF THE ERISA INDUSTRY COMMITTEE
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
HEARING ON H.R.3396
THE RETIREMENT PROTECTION ACT OF 1993
APRIL 19, 1994

PRESENTED BY
CHESTER S. LABEDZ, JR.
VICE PRESIDENT, HUMAN RESOURCES
TEXTRON DEFENSE SYSTEMS

Chairman Rostenkowski and members of the Committee, good morning. My name is Chester S. Labedz, Jr. I am pleased to appear before you today on behalf of The ERISA Industry Committee, generally known as "ERIC."

I am the Chairman of ERIC's Title IV Task Force. In that capacity I have participated actively in the formulation and presentation of ERIC's positions on pension funding and termination insurance issues for many years. I also serve as Vice President - Human Resources at Textron Defense Systems.

THE ERISA INDUSTRY COMMITTEE

ERIC represents the employee benefits interests of the nation's largest employers. Nearly all of ERIC's members employ more than 10,000 employees, and a number of them have hundreds of thousands of employees. As sponsors of pension and savings plans covering millions of participants and beneficiaries, ERIC's members share with the members of this Committee a strong interest in the success, expansion, and security of the private-sector employee benefit plan system.

Virtually all of ERIC's members sponsor one or more defined benefit pension plans. These plans have been remarkably successful in addressing the retirement security needs of millions of employees and their beneficiaries.

ERIC has vigorously supported in the past, and continues to support, strong pension funding standards and a sound termination insurance program. Over the years, ERIC has devoted thousands of hours and committed a substantial portion of its resources to a continuing legislative effort to improve pension funding and strengthen the single-employer termination insurance system.

On June 8, 1993, ERIC presented to the Congress and the Administration a plan to strengthen pension funding rules and the government program that guarantees benefits under defined benefit pension plans. The proposal reflects the consensus of a broad range of major employers, including both those sponsoring fully funded plans and those sponsoring less than fully funded plans. The ERIC proposal represents our collective views on changes needed to provide an effective and coherent structure for funding defined benefit pension plan promises. This proposal, together with additional proposals that ERIC has developed, are included as Attachments "A", "B", and "C" to my written statement, and I respectfully ask that the attachments, as well as my written statement, be included in full in the hearing record.

ERIC SUPPORTS A STRONG DEFINED BENEFIT PLAN SYSTEM

A vibrant defined benefit plan system and a sound termination insurance program require a regulatory environment that --

- encourages the formation and continuation of voluntary pension plans,
- encourages employers to make only the pension promises they can keep and to keep the promises they make,
- does not give employers a blank check on which they can make pension promises that they cannot keep, but that will be guaranteed by the government and paid for by other employers, and

- protects employees where protection is necessary and consistent with the foregoing principles.

The private pension system is a voluntary system. To the extent that employers cease forming new plans or terminate existing plans, retirement security is diminished: fewer workers earn pension benefits, the termination insurance premium based is eroded, and the retirement security of all workers is weakened. While sound funding standards are essential to the success of the private pension system, any revisions to the funding standards or to the termination insurance program that make excessive demands on employers will discourage the formation and expansion of pension plans.

The premium rates under the termination insurance program raise a similar issue. While the Pension Benefit Guaranty Corporation (PBGC) requires premium payments in order to meet part of its obligations, we are gravely concerned that excessive PBGC premiums will escalate an exodus from defined benefit plans.

The termination insurance system cannot survive if, as a result of blank checks against the system, pension promises are guaranteed by the PBGC and financed by other employers. This practice is incompatible with sound financial management.

Moreover, in the collective bargaining context, current law also gives precisely the wrong incentive to a union negotiating with a financially pressed employer: it encourages the union to bargain for additional pension benefits knowing that the termination insurance program will guarantee unfunded promises.

ERIC's June 1993 proposal (see Attachment A) includes provisions to address this problem directly. The May 27, 1993, report of the Subcommittee on Oversight to the Committee on Ways and Means also targeted this problem as one requiring resolution.

THE CENTRAL ISSUES

We believe that, in its consideration of H.R.3396, the Committee should address the following checklist of central issues:

- Should employers continue to be given blank checks to make pension promises that are guaranteed by the PBGC and financed by other employers?

- Should the PBGC's guarantees apply even before the plan's benefits are scheduled to be funded or should the guarantees be linked to the funding of the plan's benefits?

- Are defined benefit plans, and the employees who participate in them, best protected by increasing the PBGC's revenues or by improved funding of the defined benefit plans themselves?

- Should the pension funding standards be designed to require an employer to make substantially greater pension contributions <u>after</u> the plan's financial condition has become a problem or should the funding standards be designed to assure strong funding <u>before</u> that time?

- Should the pension funding standards require contributions that are volatile and unpredictable or contributions that are stable and predictable?

- What is the proper balance between imposing strong funding standards and not impairing a company's ability to operate productively?

- If Congress imposes stronger funding standards, should the new standards apply to benefits that were adopted in the past, in reliance on the funding standards then in effect, or only to benefits adopted in the future, after the employer has been put on notice of the new funding standards?

- Should the tax-law limits on the deductibility of pension contributions discourage contributions to pension plans that need additional funding, or should the limits be increased where needed to encourage strong funding?

- Does improving the security of the private pension system require the PBGC to be authorized to intervene in, and possibly disrupt, bona fide sales and dispositions of businesses?

H.R.3396 AND ERIC's PROPOSAL

Although H.R.3396 is intended to address pension funding and security issues constructively, we do not believe the bill addresses the fundamental problems facing defined benefit plan funding.

THE BLANK CHECK. Unlike ERIC's proposal or the Oversight Subcommittee's May 1993 Report, H.R.3396 does not directly address what we have described as the "blank check," that is, the current law incentives for employers and unions to agree to provide pension benefits at the expense of the PBGC and the other employers who pay PBGC premiums. If H.R.3396 is enacted, employers and unions can continue to increase pension benefits and to have those benefits guaranteed by the PBGC, without regard to the likelihood that the cost of those benefits will be passed on to other employers. No insurance company in the private sector would insure a risk under these circumstances, and the PBGC should not be required to do so either.

H.R.3396 does require more rapid funding of new benefit increases. However, the structure of the bill's requirements not only leaves the PBGC exposed but, is so harsh and volatile that it will cause serious harm to the defined benefit system, especially after the end of the temporary protection provided during the bill's transition period.

The Oversight Subcommittee's report recommends that underfunded pension plans not be allowed to promise additional pension benefits that are not, at a minimum, 90% funded or collateralized. This proposal addresses the "blank check" problem directly, but in a way that severely impairs the financial health of businesses (e.g. increased borrowing costs, loss of capital, etc.) regardless of whether or not they propose pension benefit increases.

By contrast, the ERIC proposal calls for linking the extent of the PBGC's guarantee to the plan's funded status. The law already recognizes that it is inappropriate to extend PBGC guarantees to business owners before the plan's benefits are scheduled to have been adequately funded. ERIC urges that the concept of linking guarantees to scheduled funding be applied to all employees.

Under ERIC's proposal, for future amendments to plans that are less than 100% funded, the PBGC guarantee would be phased in and tied to the minimum funding schedule. Thus, if ERIC's funding proposals are adopted, guarantees would phase in over 5 or 10 years, depending on the minimum funding period. We recognize this is a change in the rules; thus, as a matter of equity, guarantees that are already in effect, as well as the guarantees that apply to all of the benefits provided under the plan's current provisions, would continue to be governed by current law. In addition, under the ERIC proposal, if funding falls below the minimum required (for example, during bankruptcy or during the period a funding waiver is in effect), increases in the PBGC guarantee would be halted.

We find that ERIC's direct approach is, in fact, far less disruptive to both plan sponsors and plan participants than the provisions of H.R.3396 or the recommendation of the Subcommittee. We would be pleased to work with the Committee on approaches that address the "blank check" problem with minimal disruption to plan sponsors and those who depend on these plans for their retirement security.

PREMIUM INCREASE OR INCREASED FUNDING? H.R.3396 appears to be designed primarily to protect the PBGC, rather than the plans that the PBGC insures. For example, the bill proposes a substantial increase in PBGC premiums by lifting the dollar limit on the variable rate premium. In our view, however, the central focus of any legislation should not be to "fix" the PBGC, but should be to place the private pension system on a solid foundation. A premium increase will not do this. In fact, if the pension funding standards are appropriately reformed, the premium rate can be and should be reduced. This must be done if we are to maintain a vibrant defined benefit plan system.

In recent years, the premium rate has skyrocketed from $2.60 per participant (as recently as 1985) to the current rate of $19 per participant plus a variable premium, for a total of as much as $72 per participant. These substantial premium increases are already driving employers out of the defined benefit system, thereby narrowing the PBGC's premium base and weakening the program that the premiums are intended to support.

Unlike conventional insurance premiums, termination insurance premiums are not voluntary payments; they are, in effect, taxes that must be paid by defined benefit plans and the employers that sponsor them. If an employer objects to the high cost of termination insurance premium/taxes, it cannot simply decide to purchase insurance elsewhere or choose to go without insurance. The employer's alternative is to terminate its existing plans (or refuse to expand them) and decline to establish new plans for its employees. Because a pension retreat will reduce the flow of premiums to the PBGC, increasing premiums poses a very real risk to the termination insurance system.

We are keenly aware that to the extent that PBGC insurance applies, the PBGC must cover the cost of unfunded benefits by attempting to collect employer liability payments from the employer that sponsored the plan and by collecting mandatory annual premium taxes from other plan sponsors. In consequence, as the sponsors of on-going pension plans, ERIC's members have a strong interest in the sound funding of both their own plans and the plans of other employers.

Any legislation in this area should be designed to avoid the need for future premium tax increases and should set the stage for premium reductions in the future. ERIC's proposal does just that. Because ERIC's proposal strengthens the minimum funding standards and brings the PBGC guarantee into conformity with the basic funding schedule, the practical consequence will be that, after a transition period (that is, after today's guaranteed benefits are funded), the PBGC's risk will be limited to actuarial losses, and the stage will be set for the reduction of premium taxes in the future.

REVISED FUNDING STANDARDS. Although H.R.3396 revises the current pension funding standards, it does so primarily by increasing the "deficit reduction contribution" requirements of current law and expanding its application to a broad spectrum of circumstances. (The deficit reduction contribution of current law is a funding requirement that is applied in addition to normal funding requirements.

It is a mistake to focus on the deficit reduction contribution to remedy the current problems of the defined benefit system. The deficit reduction contribution applies only to those plans whose funding condition is less than optimal and thus applies only after the plan has experienced funding difficulties. A deficit reduction contribution is thus an after-the-fact remedy.

The deficit reduction contribution requirement also significantly increases the volatility and unpredictability of the funding requirements. A plan can be subject to the deficit reduction contribution requirement in some years but not in others, depending on interest rate fluctuations, collective bargaining cycles, investment performance, and other variables -- many of which are outside of the control of the plan sponsor. As a result, a plan can be subject to markedly different contribution requirements from one year to the next, depending on whether the deficit reduction contribution requirement applies in that year. Highly volatile and unpredictable contribution requirements discourage employers from adopting or expanding defined benefit plans and make it difficult for companies to make reliable long-term plans and expand. This is not in the interest of our economy or the defined benefit plan system.

In addition, the deficit reduction contribution often saddles an employer with its heaviest funding obligations at the time it can least afford to bear them: when the employer's financial condition is weak. Deficit reduction contributions thus can impair the ability of an employer to recover from its current financial difficulties.

Similarly, delaying funding requirements until a deficit reduction requirement applies fails to take full advantage of incentives an employer has to keep its plans well funded under recent accounting rules (i.e., FAS 87) that act to increase borrowing costs for employers with underfunded plans. Thus, in its study of alternative methods to increase funding in defined benefit plans, ERIC rejected proposals relying on the deficit reduction contribution.

We recommend that the Committee focus instead on fashioning strong and appropriate basic funding standards that require an employer to make larger contributions earlier, before the plan is subject to a deficit reduction contribution requirement.

Consistent with what I have said, ERIC's proposal accelerates the funding of the benefits created by new plan amendments and other items in the basic funding standard account. ERIC does not propose to change the deficit reduction contribution. In general, under ERIC's proposal, if, after the adoption of a plan amendment increasing benefits, a plan's current liability exceeds the value of the plan's assets, new amortization bases will be established to accelerate funding for the additional accrued liability under the plan's funding method. New unfunded current liabilities caused by past service amendments for active employees would be amortized over 10 years. New unfunded current liabilities caused by past service amendments for already-retired or terminated employees would be amortized over 5 years. In addition, the funding requirements for plans that are less than 100% funded would be required to take into account all promised benefit increases, including increases scheduled to become effective in future years (that is, not just the first-year benefit increase under a 3-year collective bargaining agreement).

The ERIC proposal also would impose special rules for a plan with assets that are less than 75% of the plan's current liability.

APPLICATION OF NEW STANDARDS TO PRIOR BENEFITS. H.R.3396 does not distinguish between benefits that are already provided under a pension plan and those that are added to the plan in the future (after the new funding standards are enacted). However, when employers agreed in the past to amend their plans to increase benefits, they did so in reliance on the estimated costs of the benefits as determined under the funding standards in effect at that time. It would be inequitable for Congress now to make dramatic retroactive changes in employers' funding obligations, long after the employers became obligated to provide the additional benefits and before the employers had any knowledge of the additional costs that any new funding standards would impose.

We therefore support applying stronger funding standards to less than fully funded plans on a prospective basis. If an employer knows in advance that it will be subject to more stringent funding standards, it can then decide in advance whether it can afford to increase both benefits and funding of a less than fully funded plan. Accordingly, ERIC's funding proposal applies to benefits created by plan amendments adopted in the future. The funding of benefits paid pursuant to pre-existing plan provisions would continue to be governed by prior law.

Instead of following an inappropriate, broad, retroactive approach, ERIC proposes generally prospective changes but has isolated those few specific areas where remedial action is appropriate to maintain the integrity of the basic funding rules.

Specifically, the ERIC proposal would impose special rules for plans with unfunded current liabilities that have lump sum payment provisions or that purchase annuity contracts. Under the ERIC proposal, the amortization period for any plan amendment would not be less rapid than the rate at which the liability created by the amendment is paid out. If new or increased lump sums (or annuity premiums) are paid in any year, funding at least equal to those amounts would be required for that year. Furthermore, to the extent that lump sum payments (or annuity premiums) under a plan with unfunded current liability reduce the plan's funded ratio, contributions to offset that decline should be made for that plan year.

ERIC's proposal also requires all plans (regardless of funded status) to amortize actuarial gains and losses over a 10-year period for both minimum funding and tax deduction purposes. However, a plan that is less than 100% funded would be required to amortize losses over a 5-year period for both minimum funding and tax deduction purposes. Under the ERIC proposal, if there is a change in the actuarial assumptions for a plan that is less than 100% funded, both the change and the reasons for the change would be required to be disclosed in the plan's Annual Report on Internal Revenue Service (IRS) Form 5500.

TAX DEDUCTION LIMITS. When employees participate in both a defined contribution plan and a defined benefit plan, the amount of the employer's contributions to the plans that is deductible is limited by section 404(a)(7) of the Internal Revenue Code. The aggregate deduction limit is the greater of (1) 25% of the compensation paid to participating

employees or (2) the plan's unfunded current liability (as determined under Code section 412(l) of the Code).

Any amount contributed in excess of this limit is not deductible and is subject to a 10% excise tax. As a result, section 404(a)(7) strongly discourages an employer from making a contribution that exceeds the minimum required under current law even though the contribution could bring the employer's plan up to fully funded status.

H.R.3396 inadequately addresses this problem. The bill merely exempts certain contributions from the excise tax to the extent they do not exceed the employees' elective deferrals and employer matching contributions under the defined contribution plan up to 6% of compensation. Because the bill does not change the underlying deduction limit, it does not go nearly far enough in removing the current obstruction to funding.

ERIC's proposal, by contrast, would eliminate the deduction problem by amending section 404(a)(7) to permit an employer maintaining both a defined benefit plan and a defined contribution plan to deduct (1) contributions to fund the defined benefit plan's unfunded current liability, as if the employer did not maintain a defined contribution plan, and (2) the employer's contribution to its defined contribution plan.

ERIC's proposal also would conform the limits on the deductibility of plan contributions to the minimum funding requirements. Current law requires spreading the costs of certain events over a period of at least 10 years for tax deduction purposes. Under ERIC's proposal, this period would be changed to the lesser of 10 years or the period required under the minimum funding standards.

<u>PBGC INTERVENTION</u>. H.R.3396 requires employers with more than $50 million in unfunded vested benefits to give advance notice to the PBGC of certain business sales and other dispositions and allows the PBGC to hold up the transaction and to bring an enforcement action in court if the parties do not meet any demands that the PBGC makes to protect its interests (such as by seeking additional funding or collateral).

We strongly oppose this provision. The provision will allow the PBGC to interfere with and disrupt many normal business transactions that do not involve abuse or pension considerations. The PBGC will have undue leverage in these circumstances. If the parties wish to consummate a proposed transaction, they will have no practical alternative to meeting the PBGC's demands. Moreover, in many cases, if a transaction cannot be consummated promptly, it will not be consummated at all. As a result, a PBGC demand too often will terminate a proposed transaction.

It is important to understand that these provisions will affect <u>all</u> businesses, not just businesses with underfunded pension plans. Businesses with well-funded plans may be forced into inferior business arrangements by the prospect of PBGC interference with business decisions (for example, an acquisition or joint venture of a company with underfunded plan by a company with a fully funded plan). Businesses with underfunded plans will have their economic health materially harmed because they will find the uncertainty of PBGC interference will mean fewer companies are willing to engage in normal business operations with them. This circumstance will gravely harm both the security and strength of the defined benefit system.

The PBGC should not be given this inordinate authority. Although there is a substantial risk that the proposed provision will interfere with, and even prevent, commonplace and unobjectionable business transactions, the Administration has not shown that the provision is essential to improving the PBGC's financial condition. The key to the security of the private pension system and the PBGC is <u>improved funding</u>, not the introduction of unnecessary and disruptive enforcement techniques.

<u>PARTICIPANT NOTIFICATION</u>. H.R.3396 requires the administrator of an underfunded plan to notify plan participants about the plan's funded status and the limits on the PBGC guaranty if the plan terminates while the plan is underfunded. An underfunded plan would be defined as a plan required to pay the variable rate premium.

ERIC believes that a notice of this kind will confuse and needlessly alarm participants. Participants already receive a description of the plan's financial condition in the summary annual reports that are distributed to them each year and a description of PBGC

insurance protection in the plan's summary plan description. There is no need to superimpose an additional notification requirement that will be, at best, redundant and, at worst, confusing and alarming.

Moreover, the Department of Labor is currently undertaking a review of ERISA's reporting and disclosure requirements. It would be premature for Congress to take action in this area until the Department completes its review.

We are particularly concerned that, under H.R.3396, the PBGC would be given the authority to specify the form and content of the notice. The notice could too easily be misapprehended as a device to pressure employers into accelerating pension contributions than with presenting a realistic assessment of the likelihood of a plan termination. The likelihood that a less than fully funded plan will be terminated depends principally on the employer's financial condition, not on the plan's financial condition. Unless the proposed notice addresses this point, the notice will needlessly alarm countless participants and beneficiaries whose plans will never be terminated.

BANKRUPTCY. H.R.3396 proposes to amend both ERISA and the Internal Revenue Code to prohibit a company in bankruptcy from amending a defined benefit plan unless the benefit increase does not become effective until after the effective date of the employer's reorganization plan. However, this provision would not affect benefit increases under pre-bankruptcy plan provisions and collective bargaining agreements. In addition, H.R.3396 provides that if a contributing sponsor or controlled group member liquidates substantially all of its assets in an insolvency proceeding, it would be liable for the plan's underfunding as if the plan had been terminated.

ERIC's proposal takes a different approach. ERIC's proposal supports conforming the Bankruptcy Code with the provisions of ERISA by amending the Bankruptcy Code to (a) recognize pension contributions as administrative expenses that are paid during bankruptcy and (b) strengthen the PBGC's claim to contributions that are missed before the plan sponsor filed for bankruptcy. Under the ERIC proposal, the PBGC also would have the option to join unsecured creditors' committees. In addition, ERIC's proposed changes in the PBGC guarantee, which I described earlier, will prevent companies from increasing the PBGC's exposure while they are in bankruptcy.

BUDGET RULES. H.R.3396 does not alter the fact that any changes in the pension funding requirements and the tax deduction limits are subject to the pay-as-you-go budget rules. By contrast, the ERIC proposal calls for removing changes in the funding requirements and tax deduction rules from the budget's pay-as-you go requirements. We urge the Committee to give serious thought to this proposal. Defined benefit plans are long-term financial arrangements, and it is therefore wholly inappropriate to account for changes in the funding and tax deduction rules on a pay-as-you-go basis. Improvements in pension funding will reduce PBGC's liabilities in the long run, and they should not have to be balanced by increases in current government revenues.

REVENUE-DRIVEN PROPOSALS. H.R.3396 includes a number of proposals that are extraneous to the bill's objectives and that appear to be included in the bill primarily because they raise revenue.

First, H.R.3396 reduces the limits imposed by section 415 and other provisions of the Internal Revenue Code on the benefits and contributions under tax-qualified plans. The bill effects the reduction by providing that the cost-of-living adjustments to the limits will be made in specific increments (of $5,000, in the case of the section 415 limits), rounding down to the next lowest multiple of the prescribed increment. Although the Administration has claimed that this proposal is designed to reduce "unnecessary complexity and expense," this is a problem that few, if any, have complained about. Certainly ERIC member have not complained about it. The clear purpose and effect of the proposal is to raise revenue by delaying the cost-of-living adjustments and thereby effectively reducing the Internal Revenue Code limits.

In order to increase retirement security, the section 415 limits should be increased, not decreased. The section 415 limits, and particularly the limits for early retirees, are now so low that substantial numbers of rank-and-file employees are regularly receiving benefits from unfunded plans. Because the Administration's proposal will increase this trend, it will diminish the retirement security of countless rank-and-file workers.

As an alternative to the revenue-driven proposals in H.R.3396, ERIC developed additional proposals that we urge the committee to adopt. First, ERIC bas proposed a package of amendments to the Internal Revenue Code that will (1) increase tax revenue, (2) reduce administrative costs, and (3) increase corporate executives' interest in maintaining well-funded pension plans. The ERIC proposal would repeal section 415(e), amend section 401(a)(16) to allow plans that are in full funding to pay excess plan benefits, and amend section 420 to extend and expand the ability of plan sponsors to use any extra assets to pay retiree medical benefits. ERIC's proposal is described in greater detail in Attachment B to this statement.

Second, ERIC developed modifications to the Administration's proposal in H.R.3396 to eliminate the ability of defined contribution plans (other than certain target benefit plans) to satisfy the Treasury Department's nondiscrimination requirements by cross-testing on a benefits basis. The Administration proposal is irrelevant to the central concern of the bill: the security of the defined benefit plan system.

The proposal appears to be motivated not by concern for the security of defined benefit plans, but by revenue considerations and concerns regarding the application of the Treasury's recently issued nondiscrimination regulations to defined contribution plans. In any event, the proposal is far broader than necessary to achieve these aims. There are many large, long-standing, and nondiscriminatory plans that rely on cross-testing, and Administration representatives have stated publicly that the Administration does not intend to prohibit these plans from continuing to use cross-testing. Accordingly, the Administration's proposal must be substantially narrowed. Attachment C to this statement presents ERIC's recommendation on how to refine the Administration's over-broad cross-testing proposal.

LUMP SUM DISTRIBUTIONS. H.R.3396 requires that a lump sum distribution paid by a plan not be less than the value of the participant's pension benefit, determined on the basis of the 30-year Treasury bond interest rate and the mortality table that the Internal Revenue Code specifies for insurance companies to determine reserves for group annuity contracts.

Although ERIC's proposal does not address this point, ERIC supports legislation that would make the applicable interest rate more realistic. ERIC welcomes the opportunity to work with the Committee and its staff to address this issue.

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Thank you, Mr. Chairman. ERIC looks forward to working with the Committee and its staff on improvements in the funding standards and the termination insurance program for defined benefit pension plans.

THE ERISA INDUSTRY COMMITTEE

Pension Funding and ERISA Title IV:
A Proposal For Reform
(Attachment A)

The ERISA Industry Committee (ERIC)[1] has for many years recognized that something must be done to strengthen defined benefit pension plan funding and the Pension Benefit Guaranty Corporation's (PBGC) termination insurance program. We have been in the forefront of efforts to strengthen plan funding and the termination insurance system. Over the past year, a task force that included a cross-section of ERIC members from a variety of industries has worked intensely to develop recommendations for remedial legislation.

As a result our task force's efforts, ERIC has adopted a proposal that is designed to protect defined benefit plans and their participants through a combination of accelerated funding for plans with unfunded current liabilities, coordinating the funding rules with the tax deduction rules and PBGC guarantees, and clarifying and reforming the PBGC's status in bankruptcy.

ERIC does not believe that "fixing the PBGC" should be the central focus of reform. If more money is to be committed to the defined benefit plan system, it should be invested where it will do the most good: in the pension plans themselves in the form of increased funding.

A premium increase is not the solution to the problems of the defined benefit plan system. With adequate funding, the premium rate can be and must be reduced if we are to maintain a vibrant defined benefit plan system.

A vibrant defined benefit system includes a sound termination insurance program and a regulatory environment that:

- encourages the formation and continuation of voluntary pension plans;
- encourages employers to make only the pension promises they can keep, and to keep the promises they make; and
- does not give employers or unions a blank check on which they can make pension promises that they cannot keep but that will be guaranteed by the Government and other employers.

The formation and continuation of voluntary pension plans is essential to the health and success of the defined benefit plan system. With the work force growing older and more sensitive to retirement, workers will be seeking greater retirement security. In many cases, that will mean increased pressure for defined benefit pensions.

ERIC believes that sound funding and sound funding standards are the key to greater security for defined benefit pension plans and the employees who participate in them. Revisions to the funding standards or to the termination insurance program must not make unreasonable demands that will discourage plan formation and continuation.

If employers cease to form new plans and begin to terminate existing plans, retirement security will be diminished for all workers. Thus, any change in the funding standards must strike a balance between the need for sound funding, on the one hand, and the need to preserve and expand the private pension system, on the other.

ERIC supports applying stronger funding standards to less than fully funded plans on a prospective basis. If an employer knows in advance that it will be subject to more stringent funding standards, it can then decide in advance whether it can afford to increase benefits and funding in a less than fully funded plan.

When employers agreed in past years to amend their plans to increase benefits, they did so on the basis of the estimated costs of the benefits in reliance upon the law's existing funding standards. Thus, it would be inequitable for Congress now to make dramatic retroactive changes in employers' funding obligations,

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[1] *The ERISA Industry Committee (ERIC) is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers and is the only organization representing exclusively the employee benefits interests of major employers. ERIC's members provide comprehensive retirement, health care coverage and other economic security benefits directly to some 25 million active and retired workers and their families. The association has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.*

long after the employers became obligated to provide the additional benefits and before the employers had any knowledge of the additional costs that any new funding standards would impose.

Employers should not make, nor should unions demand, pension promises that cannot be kept. As the termination insurance program's premium payers and as those who bear the cost of the unfunded guaranteed benefits promised by terminated plans, we support measures to assure that employers keep their pension promises and to limit the pension benefits that the PBGC guarantees.

In the collective bargaining context, current law also gives precisely the wrong incentive to a union: it encourages a union to bargain for additional pension benefits from a financially-pressed employer. The union knows that if the employer is unable to fund the additional benefits, the termination insurance program will provide them.

The termination insurance system cannot survive if the law provides a blank check that can be used to make pension promises that are guaranteed by the PBGC and financed by other employers.

We therefore support an approach that would more closely link the extent of the PBGC's guarantee to the plan's funded status. The law already recognizes that it is inappropriate to extend PBGC guarantees to business owners before the plan's benefits are scheduled to have been adequately funded. ERIC urges that the concept of linking guarantees to scheduled funding be extended to all employees.

ERIC strongly opposes a premium increase as a remedy for the ills of the termination insurance program. In recent years, the premium rate has skyrocketed from $2.60 per participant (as recently as 1985) to the current rate of $19 per participant plus a variable premium of as much as $53 per participant -- an aggregate premium of as much as $72 per participant.

These substantial premium increases are already driving employers out of the defined benefit system, thereby narrowing the PBGC's premium base and weakening the program that the premiums are intended to support.

In ERIC's view, any legislation in this area should be designed to avoid the need for future premium increases and to set the stage for premium reductions in the future.

THE ERISA INDUSTRY COMMITTEE

Pension Funding and ERISA Title IV:
A Proposal For Reform
June 8, 1993

I. In General

A. ERIC supports protecting defined benefit plans and their participants through a combination of accelerated funding for plans with unfunded current liabilities, coordinating the funding rules with the tax deduction rules and PBGC guarantees, and clarifying and reforming the PBGC's status in bankruptcy.

B. The current funding rules do not work for all types of plans, in particular, flat dollar plans and plans with lump-sum payouts.

C. However, certain legislative proposals that have been made are unfair and are potentially counterproductive.

II. Minimum Funding Requirements

A. Any proposal to mandate accelerated funding should relate primarily to future plan amendments.

1. Companies cannot reduce the benefit promises they made in the past. They granted benefit improvements on the basis of their ability to fund the improvements in accordance with current law (i.e., over 30 years or at the percentages specified in OBRA '87).

2. At this time, a change in the minimum funding requirements for benefit promises made in the past would be unfair: it would change the rules in the middle of the game.

B. The minimum funding schedule for plan amendments adopted after December 31, 1992, should be accelerated to the extent these amendments cause the plan to have unfunded current liability on a termination basis or increase the unfunded current liability of a plan that already has unfunded current liability.

1. New unfunded current liabilities caused by past service amendments related to active employees should be amortized over 10 years.

2. New unfunded current liabilities caused by past service amendments related to already-retired or terminated employees should be amortized over 5 years.

3. A shutdown, "window," or similar benefit should be treated as a plan amendment for already-retired employees, effective when the event occurs, and should be amortized over the lesser of (a) 5 years or (b) the weighted-average payout period for the benefit.

4. The funding requirements for plans that are less than 100% funded[1] should take into account all promised benefit increases, including increases scheduled to become effective in future years (*i.e.*, not just the first-year benefit increase under a three-year agreement). This treatment should be optional for plans that are at least 100% funded after reflecting the amendments.

5. Special rules for plans with unfunded current liabilities that have lump-sum payment provisions.

a. The amortization period for any plan amendment should not be less rapid than the rate at which the liability created by the amendment is paid out. If new or increased lump-sum amounts are paid in any year, funding at least equal to those amounts should be required for that year.

b. To the extent lump-sum payments in a plan with unfunded current liability decrease the plan's funded ratio, contributions to offset that decline should be made for that plan year.

c. The foregoing rules should apply to plans that purchase annuity contracts as well as to plans that provide for lump sums.

6. Special rules would apply to plans with substantial unfunded current liabilities.

C. Detailed Funding Rules

1. This proposal modifies the speed of funding new plan amendments and other items under §412(b). Section 412(l) remains in effect.

2. If a plan has assets (not reduced by any credit balance) less than its current liability

(measured as under current law) after a plan amendment increasing benefits, two (or three) new amortization charge bases will be established under I.R.C. §412(b) to effect faster funding for the additional accrued liability under the plan's funding method:

a. First, to the extent the accrued liability for active participants increases, a 10-year base is established.

b. Second, to the extent the accrued liability for retired and terminated participants increases, a 5-year base is established.

c. These bases will be replaced with a 30-year base to the extent of the amount by which the assets exceeded the plan's current liability immediately before the amendment.

3. If a plan has assets (not reduced by any credit balance) less than 75% of the plan's current liability (measured as under current law) as of the beginning of the year, the following rules will apply:

a. If the valuation interest rate exceeds the Current Liability Base Rate (i.e., 100% of the current liability base rate under I.R.C. §412(b)(5)), the interest rate used to compute all minimum funding standard account charges and credits under I.R.C. §412(b) (but not under I.R.C. §412(l)) must be changed to a rate not higher than the Current Liability Base Rate.

b. The plan will be subject to a minimum funding requirement equal to the greater of the amount otherwise required by this proposal or the following:

i. Interest (determined on the basis of the current liability interest rate) on the plan's unfunded current liability; plus

ii. The normal cost (on a current liability basis) under the unit credit method accrued during the year; plus

iii. The current year's amortization of outstanding funding waivers.

Any credit balance in the plan's funding standard account will be available to meet this requirement.

4. The required change to the Current Liability Base Rate will be treated in the minimum funding standard account as any other change in the valuation interest rate.

a. Each existing amortization base will continue to be amortized over its remaining amortization period, although the annual charge or credit will change due to the interest rate change.

b. A new amortization base will be created equal to the increase in accrued liability due to the interest rate change. This base will be amortized over 10 years.

5. If a phased-in increase in benefits is negotiated under a plan that is less than 100% funded, the funding standards should immediately reflect the full extent of the benefit increase promised, regardless of whether the full amount of the increase is effective immediately. This treatment should be optional for a plan that is at least 100% funded.

6. All plans (regardless of funded status) should amortize actuarial gains and losses over a 10-year period for both minimum funding and tax deduction purposes, except that a plan that is less than 100% funded should be required to amortize losses over a 5-year period for both minimum funding and tax deduction purposes.

a. The current liability under a newly established plan should be amortized over 10 years.

7. If there is a change in the actuarial assumptions for a plan that is less than 100% funded, both the change and the reasons for the change should be disclosed in the plan's Form 5500.

8. The foregoing provisions will be effective for plan amendments adopted after December 31, 1992.

D. Appended to this proposal are a table that summarizes the proposal and examples that illustrate how the proposal will work.

Tax Deduction Limits

A. Conform the limits on the deductibility of plan contributions to the minimum funding

requirements. Current law requires spreading the costs of certain events over a period of at least 10 years for tax deduction purposes. This period should be changed to the lesser of 10 years or the period under the minimum funding rules.

B. Amend the 25% deduction lim t in I.R.C. §404(a)(7) to permit an employer that maintains both a defined benefit plan and a defined contribution plan to deduct

1. Contributions to fund the defined benefit plan's unfunded current liability, as if the employer did not maintain a defined contribution plan, and

2. The employer's contribution to its defined contribution plan.

IV. PBGC Guarantees

A. For new plan amendments, the PBGC guarantee should be phased in and tied to the minimum funding schedule for plans that are less than 100% funded. Thus, guarantees should phase in over 5 or 10 years, depending on the minimum funding period.

B. For new plan amendments, the minimum annual increase in the guarantee of $20 per month should be rescinded.

C. The rights of participants and beneficiaries in the event of plan termination should be changed to conform to the proposed change in the guarantee phase-in rules; as yet unfunded (and thus unguaranteed) liabilities related to amendments after December 31, 1992, should be placed last in the asset allocation schedule that appears in ERISA §4044.

D. If funding falls below the minimum required (*e.g.*, in bankruptcy or during the period for which a funding waiver is in effect), the increase in the PBGC guarantee will be halted. No funding means no guarantee.

E. The practical consequence of ERIC's proposal is that after a transition period (i.e., after today's guaranteed amounts are funded), the PBGC's risk will be limited to actuarial losses.

V. Bankruptcy

A. ERIC supports conforming the Bankruptcy Code with the provisions of ERISA. ERIC supports amending the Bankruptcy Code to (a) recognize pension contributions as administrative expenses that are paid during bankruptcy and (b) strengthen the PBGC's claim to contributions missed before the plan sponsor filed for bankruptcy.

B. The proposed changes in the guarantee provisions, described above, should prevent companies from increasing the PBGC's exposure while they are in bankruptcy.

C. The PBGC also should have the option to join unsecured creditors' committees.

D. ERIC does not support increasing the PBGC's claim above the historic 30% of net worth limit; this could damage the interests of existing creditors and could cause creditors to try to negotiate to improve their credit positions. This could seriously damage a company's access to the credit markets.

VI. PBGC Premiums

A. ERIC's proposal should allow near-term (if not immediate) reduction in PBGC premiums.

VII. Budget Rules

A. ERIC supports removing changes in the funding requirements and tax deduction rules from the budget's pay-as-you-go requirements. Improvements in pension funding will reduce the PBGC's liabilities in the long run, and should not have to be balanced by increases in current Government revenues.

VIII. No Future Changes

A. If ERIC's proposal is adopted, it is anticipated that no additional changes to the law to protect plan participants or to manage the PBGC liability will have to be considered for many years and that premium reductions can be enacted.

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SUMMARY

Percent Funded	Treatment of Plan Amendment Liabilities	FSA Interest Rate Requirement
100% +	Current law • 30-year amortization • May incorporate bargained benefit increases	Current law • Actuary's "Best Estimate"
75-100%	• 5 years for retirees • 10 years for actives • Must incorporate bargained benefit increases	Current law • Actuary's "Best Estimate"
Under 75%	• 5 years for retirees • 10 years for actives • Must incorporate bargained benefit increases • Other special funding requirements apply	Change to Current Liability Base Rate

EXAMPLES

Example 1

	Prior to Amendment	After Amendment
Current Liability	\$ 90,000	\$115,000
Actuarial Value of Assets	100,000	100,000
Funded Ratio	111%	87%
Accrued Liability at Valuation Rate (Exceeding Mandated Rate)		
Actives	95,000	110,000
Retirees	25,000	40,000
New § 412(b) Amortization Bases		
(a) Tentative 10-year base for actives		\$15,000 (110,000-95,000)
(b) Tentative 5-year base for retirees		15,000 (40,000-25,000)
(c) Assets exceed prior current liability		10,000 (100,000-90,000)
(d) Adjusted 5-year base for retirees		5,000 (15,000-10,000)

Base 1: \$15,000 over 10 years
Base 2: \$ 5,000 over 5 years
Base 3: \$10,000 over 30 years

Example 2 - Next Year

	Beginning of Year
Valuation Interest Rate	9.00%
Current Liability Base Rate	8.07%
Current Liability	\$140,000
Actuarial Value of Assets	\$101,000
Funded Ratio	72%

- Because the plan is less than 75% funded at the beginning of the year, the interest rate for I.R.C. §412(b) funding calculations must be dropped from the 9.0% rate to a rate no higher than 8.07% (i.e., 100% x 8.07%).

- Calculation of the current liability and the funding charges under I.R.C. §412(l) are still based on an interest rate within the 90% - 110% corridor around the 8.07% Current Liability Base Rate.

- This change will result in significantly higher charges for the year and a larger funding requirement.

The ERISA Industry Committee

PROPOSAL TO SIMPLIFY ADMINISTRATION AND ENCOURAGE FUNDING OF PENSION PLANS
(Attachment B)

SUMMARY

Under recent changes in the law, corporate executives have less and less incentive to assure the maintenance and funding of pension plans. Not only are there multiple, costly administrative burdens associated with maintaining pension plans, also but the executive's own benefit security is increasingly divorced from the welfare of the pension plan. Federal tax revenue needs have also contributed to poor funding incentives.

This proposal would:

- ♦ Increase tax revenues;
- ♦ Decrease administrative costs; and
- ♦ Increase executives' interest in maintaining well funded pension plans by granting plans that are in full funding:
  - increased flexibility,
  - further decreases in administrative costs, and
  - additional security for certain nondiscriminatory benefits.

PROPOSAL COMPONENTS:

The proposal would involve changes to three Internal Revenue Code (IRC) sections:

1. Repeal of IRC section 415(e);
2. Amendments to IRC section 401(a)(16) to allow plans that are in full funding to pay excess plan benefits; and
3. Amendments to IRC section 420 to improve the access to and useability of provisions that allow plans that are in full funding to pay retiree health benefits.

(1) Repealing IRC section 415(e) is a key component to simplifying the administrative burden on corporate plan sponsors and would enhance incentives to maintain qualified pension plans. 415(e) coordinates the maximum benefits payable to an individual from a combination of pension and savings plans maintained by the same plan sponsor. In order to calculate whether or not a benefit is limited by 415(e), the plan sponsor must maintain records detailing pay, employee and employer contributions to savings plans, etc., for each year of the individual's employment. Keeping (and maintaining the integrity of) this data can be an enormous burden on employers. Further, the limit is inequitable in that it favors employees who have worked for multiple employers over those with stable employment. In legislation leading up to the Tax Reform Act of 1986, a 15% excise tax on excess distributions was proposed as a replacement for 415(e). The 15% excise tax was adopted, but 415(e) was not repealed. Subsequent events (such as the imposition of reduced limits under IRC section 401(a)(17) on compensation that can be used to calculate plan contributions and benefits) have further served to reduce the number of occasions that 415(e) will apply, but have not reduced the administrative burdens it imposes. Since actual limitation of benefits by 415(e) is rare, repeal of the limit is unlikely to generate significant tax revenue losses.

(2) Allowing plans that are in full funding to pay excess plan benefits would further simplify the administration of maximum benefit limits for sponsors of nondiscriminatory pension plans that are in full funding. Sponsors of these plans would be allowed to secure the provision of nondiscriminatory benefits (e.g., for disabled employees or retirees under early retirement incentive programs) that would otherwise be provided outside the pension plan (e.g., under a 415 excess plan) by paying benefits directly from the plan. This raises tax revenues, since benefits paid from accumulated pension assets would not generate a tax deduction, while benefits paid from an excess plan do generate a tax deduction. It also gives pension decision makers an incentive to better fund the pension plan so that benefits will be more secure.

(3) The proposed changes to IRC section 420 would give further incentives for maintaining a fully funded plan by extending and expanding the ability of plan sponsors to use any extra assets that arise to pay retiree medical benefits that would otherwise be paid directly by the company. This also raises tax revenues, since the benefits would not be deductible when paid from accumulated pension assets, whereas when paid directly by the sponsor a tax deduction is generated.

In summary, the proposal will reduce administrative costs for all qualified pension plans and enhance the benefit security of nondiscriminatory benefits. By reducing administrative burdens and increasing the attractiveness of maintaining a well funded pension plan, the proposal helps to preserve and promote the private pension system.

DETAILED EXPLANATION

1. REPEAL IRC SECTION 415(e)

Description

IRC section 415(e) would be repealed. Section 415(e) was adopted in 1974 as a part of ERISA. In theory, it ensures that the tax advantages of tax qualified pension plans are not overused by any individual by imposing limits on the combination of pension and defined contribution plan benefits that a company can provide to any individual.

However, in practice, 415(e) is a clumsy and administratively burdensome approach that requires extensive recordkeeping by plan sponsors. For instance, to calculate whether a benefit reduction under 415(e) would apply, a plan sponsor must keep and maintain the integrity of data showing, for each employee, pay for each year of employment, as well as contributions by both employers and employees to a variety of savings plans, ESOPs, etc. The situation can be further complicated when companies merge or transfer employees between operations that are subsequently sold. In recognition of the administrative burden, the legislation leading up to the Tax Reform Act of 1986 initially proposed a 15% excise tax on excessive distributions from tax qualified plans to replace 415(e). The 15% excise tax was adopted, however, without repeal of 415(e).

Revenue Impact

The proposal is likely to be scored as a revenue loser. However, IRC section 401(a)(17) limitations on compensation that can be taken into account for benefits and contributions to qualified plans, the extensive nondiscrimination rules in the IRC, and the IRC section 415 limits on contributions paid to and benefits paid from qualified plans, taken in combination, already constrain benefits sufficiently so that benefits generally are limited before 415(e) applies. Hence, any lost revenue should be small.

Supporting Arguments

- Simplification - reduces administrative problems in tracking annual additions for the total career of an employee. Under the proposal, data requirements will be reduced to data the employer can control (electronically) with reasonable accuracy.
- Other IRC limits on benefit payments mean that 415(e) is less likely to apply. Thus, the proposal would remove the administrative burden of maintaining data to calculate what is becoming an increasingly rare reduction in benefits.
- Improves equity by eliminating a current law bias against employees whose benefits are derived from a single employer.
- Enhances benefit security for employees whose benefits become payable from the trust.

2. AMEND IRC SECTION 401(a)(16) TO ALLOW PLANS IN FULL FUNDING TO PAY EXCESS 415 BENEFITS FOR CURRENT RETIREES

Description

A company would have the option to pay benefits above the IRC section 415 limits from the pension plan trust to retirees if the plan:
1) is fully funded (including liabilities assumed for excess benefits) for the year that the sponsor sweeps in the excess benefits, and
2) the benefits are based on a nondiscriminatory formula. For this purpose it is anticipated that the benefit formula would pass either a safe harbor or the general amount test under 401(a)(4).

Once benefits are payable from the trust, they would become a permanent liability of the plan. For funding purposes, however, the possibility of future "sweep-ins" could not be taken into consideration. As of the first plan year for which a plan adopts the provision, existing retirees would be allowed to elect whether benefits would be paid from the pension plan, or continue to be paid by the corporation. In subsequent years, new retirees would be given the opportunity to make a similar election. This means that less highly paid retirees that are affected by 415 (e.g., disabled employees or retirees under early retirement incentive programs) would be most likely to be afforded the increased benefit security of receiving benefits from the qualified pension plan Very highly compensated individuals would only be able to get the increased benefit security by paying any excise tax on excess distributions from qualified pension plans.

Revenue Impact

Raises revenue for U.S. Treasury in the near term because benefits currently being paid from the company are tax deductible; benefits paid from the pension trust are not.

The proposal will reduce the amount of current pension fund accumulations, and this amount will likely need to be made up in the future. Thus, over the long term, current Treasury revenues are increased at the expense of future revenues for ongoing plans.

Finally, the PBGC is not likely to be put at risk, since the plan must be in full funding to use the provision, and the general impact of the proposal will be to encourage full funding of plans.

Supporting Arguments

- Already a precedent in the IRC 420 transfer provisions.
- Provides benefit security to retirees.
- By increasing executive and other decision makers' interest in making sure that the plan is well funded, it should help to increase benefit security for active employees and decrease the long term risks of the PBGC.

3. MAKE SIGNIFICANT IMPROVEMENTS TO IRC SECTION 420

Description

Under current law, sponsors have the ability to use excess pension fund assets to pay retiree health benefits. To do so, the sponsor's pension and retiree health plans must meet certain requirements, including: pension assets must

exceed 125% of current liability; all pension plan participants must be vested in their accrued benefits; the employer must agree to maintain the current level of health plan contributions for at least 5 years; and the amount transferred cannot exceed one year's claim payment. The law currently has a sunset provision, so that transfers will not be available for plan years after 1995. Few plan sponsors have used the section 420 transfer rule because of the administrative costs and an unwillingness to make such a large commitment in exchange for a short-term cash flow advantage.

The proposal would:
- Extend the sunset date of the provision through the year 2000;
- Remove the 5 year maintenance of health care claims cost rule; and
- Remove the requirement to vest all pension plan participants.

Alternatively, if health care reform legislation is enacted, excess assets could be used:
- To pay any employer toll that is levied on employers in lieu of or in addition to any employer obligations for retiree health benefits.

Revenue Impact

Should raise significant amounts of revenue.

Supporting Arguments

- Many more employers will take advantage of the program than currently. This should significantly raise tax revenues.
- Faced with the inability to use pension money to pay retiree benefits, several employers have canceled their retiree medical plans, including plans affecting either future or present retirees. If companies could use excess pension money, more retirees would continue to receive a benefit.
- Past experience under the program indicates that abuse is unlikely.

THE ERISA INDUSTRY COMMITTEE

ERIC CROSS-TESTING PROPOSAL
(Attachment C)

<u>*SUMMARY*</u>

Background:
In order for an employee pension or profit-sharing plan to be tax-qualified, the Treasury's nondiscrimination regulations provide that either the amount of the benefits provided by the plan or the amount of the contributions made to the plan must not discriminate in favor of highly compensated employees. "Cross-testing" is the term used when a defined contribution plan is tested for nondiscrimination on the basis of the benefits provided, rather than on the basis of contributions made. Cross-testing frequently is used when the contributions to a defined contribution plan increase as either the age or the length of service of the employee increases. Cross-testing also is used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis for nondiscrimination purposes.

The Administration's Bill:
The Administration's pension funding and PBGC reform bill (H.R.3396/S.1780) prohibits defined contribution plans other than target benefit plans from testing for nondiscrimination on the basis of benefits rather than on the basis of contributions (i.e., prohibits defined contribution plans from cross-testing). The Administration proposed the amendment because the Treasury Department believes the cross-testing provisions of the Treasury's regulations allow defined contribution plans to make allocations that unduly favor highly compensated employees.

ERIC's Proposal:
If legislation curbing the use of cross-testing is enacted, ERIC proposes to modify the Administration's ban in order to allow nondiscriminatory defined contribution plans to continue to use cross-testing. ERIC's amendment would allow a plan to be cross-tested if the plan first passes either of two "gateway" tests. The gateways ensure either (1) that each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees or (2) that the disparity between allocation rates for highly compensated and non-highly compensated employees under the plan is reasonable.

A plan that passes either of these gateways differs significantly from the plans the Treasury has regarded as abusive.

<u>*DETAILED EXPLANATION*</u>

Background:
In order for an employee pension or profit-sharing plan be tax-qualified, the Treasury's nondiscrimination regulations provide that either the amount of the benefits provided by a plan or the amount of the contributions made to the plan not discriminate in favor of highly compensated employees. In practice, most defined benefit plans are tested according to the benefits provided by the plan, and defined contribution plans are tested according to the contributions made to the plan.

In some cases, however, a defined contribution plan is tested on the basis of the benefits provided. The process of showing that the benefits provided under a defined contribution plan are nondiscriminatory is referred to as "cross-testing".

Cross-testing frequently is used when the contributions to a defined contribution plan increase as either the age or the length of service of the employee increases. Cross-testing also is used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis for nondiscrimination purposes. Employee stock ownership plans (ESOPs), cash or deferred (§401(k)) arrangements, and employer matching (§401(m)) plans may not be cross-tested under the nondiscrimination rules on an individual plan basis, but may be cross-tested where the plan is aggregated with a defined benefit plan in order to test the plans on an aggregated basis.

The Administration's Bill:
The Administration's pension funding and PBGC reform bill (H.R.3396/S.1780) prohibits defined contribution plans other than target benefit plans from testing for nondiscrimination on the basis of benefits rather than on the basis of contributions (i.e., prohibits defined contribution plans from cross-testing).

The Administration proposed the amendment because the Treasury Department believes the cross-testing provisions of the Treasury's regulations allow defined contribution plans to make allocations that unduly favor highly compensated employees. However, the Treasury has stated that many plans that use cross-testing are nondiscriminatory, and has invited the public to suggest proposals that would allow "nonabusive" plans to continue to use cross-testing.

ERIC's Proposal:
ERIC's proposal would modify the Administration's proposal in order to allow nondiscriminatory plans to continue to use cross-testing. ERIC's proposed amendment would allow a defined contribution plan to be cross-tested (that is, tested on a benefits basis) if the plan first passes either of two "gateway" tests. The gateways ensure either (1) that each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees or (2) that the disparity between allocation rates for highly compensated and non-highly compensated employees is reasonable. (See *Gateway #1* and *Gateway #2*, below).

ERIC's proposal also modifies a statement in the Administration's explanation of its bill that would restrict

the ability to use benefit amounts calculated through cross-testing in meeting the average benefit percentage test of the nondiscrimination regulations (see *Special Rule*, below).

Under ERIC's proposal, the legislative history should state that no inference shall be drawn regarding the validity of the Treasury's nondiscrimination and coverage regulations.

Gateway #1: Under ERIC's amendment, a plan will pass the first gateway if each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees. Under the amendment, the plan will meet the first gateway if the percentage of non-highly compensated employees who benefit from each of the plan's allocation rates is greater than or equal to the unsafe harbor percentage in the Treasury's coverage requirements (see Treas. Reg. §1.410(b)-4(c)).

For example, suppose that an employer has 500 nonexcludable employees, 100 of whom are highly compensated. If all 500 employees participate in the employer's profit-sharing plan, and 25 of the highly compensated employees receive an employer contribution equal to 10 percent of pay, the plan will not pass this gateway unless at least 25 of the non-highly compensated employees receive an employer contribution of 10 percent of pay or more. A plan's failure to meet this gateway by ***de minimis*** amounts will be disregarded, as long as the failures are infrequent.

Gateway #2: A plan will pass the second gateway if it meets two requirements. The first requirement is that the average allocation rate for the non-highly compensated employees who participate in the plan be at least 70 percent of the average allocation rate for the highly compensated employees who participate in the plan. The second requirement is that the highest allocation rate for any highly compensated employee under the plan not exceed by more than 5 percentage points the average allocation rate for all of the plan's non-highly compensated employees.

For example, if the average allocation rate for the highly compensated employees who participate in the plan is 10 percent of pay, the first requirement is met only if the average allocation rate for the non-highly compensated employees who participate in the plan is at least 7 percent of pay. If the average allocation rate for the non-highly compensated employees is 7 percent of pay, the second requirement is met only if no highly compensated employee receives an allocation of more than 12 percent of pay.

For purposes of applying the second gateway, the only employees taken into account are those employees who participate in the plan. In addition, in applying both gateways, the plan may impute disparity in contributions to the extent permitted by the current nondiscrimination regulations.

Special Rule: Under the Treasury's current rules, a plan must pass one of two coverage tests: a ratio percentage test or an average benefit percentage test.[1] The Administration's explanation of its bill refers to a statutory change that would affect plans that use the average benefit percentage test. The change would prohibit an employer that applies the average benefit percentage test from determining employee benefit percentages on a benefits basis unless a substantial portion of the employer-provided benefits is provided under one or more defined benefit plans. The Administration's proposed bill, however, does not appear to include this provision.

ERIC proposes that, if this provision is included in any legislation that is enacted, it be revised to permit an employer to take the contributions under a defined contribution plan into account in meeting the average benefit percentage test on a benefits basis if the contributions (i) are nondiscriminatory in amount (i.e., on a contributions basis), (ii) satisfy either of the gateways that ERIC has proposed, (iii) are made to a target benefit plan, (iv) are made under §401(k) and meet the special nondiscrimination requirements that apply to §401(k) plans, or (v) are employer-matching contributions and meet the special nondiscrimination requirements that apply under §401(m) to employer-matching contributions.

No Inference: Cross-testing is a procedure provided for in Treasury regulations. If an amendment is enacted limiting the use of cross-testing, the legislative history should state that no inference shall be drawn from the amendment regarding the validity of the Treasury's nondiscrimination and coverage regulations.

Conclusion:

A plan that passes either of ERIC's proposed gateways differs significantly from the plans that Treasury has regarded as abusive. By meeting one of the gateway tests, a plan demonstrates that it provides nondiscriminatory contributions to the employer's non-highly compensated employees, and it is therefore appropriate to permit the plan to demonstrate that it provides benefits that are nondiscriminatory in amount.

Similarly, a plan that meets any one of the requirements of the proposed special rule has already met other tests that demonstrate that the plan is nondiscriminatory, and it is therefore appropriate to permit the employer to aggregate that plan with others to demonstrate that the employer's plans provide benefits that are nondiscriminatory in amount.

[1] Under the coverage requirements set out in Internal Revenue Code §410(b), a plan must meet either of two tests: a "ratio percentage test" or an "average benefit percentage test". A plan meets the ratio percentage test if (1) 70% of the employer's non-highly compensated employees participate in the plan or (2) if the percentage of non-highly compensated employees participating in the plan is at least 70% of the percentage of highly compensated employees participating in the plan. A plan meets the average benefit percentage test if (1) the plan benefits a nondiscriminatory classification of employees (as determined by regulation) and (2) the average benefit as a percentage of pay for the non-highly compensated employees is at least 70% of the average benefit as a percentage of pay for the highly compensated employees.

STATEMENT OF JAMES G. DURFEE, CHAIRMAN, PENSION FUNDING TASK FORCE, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS; AND VICE PRESIDENT, TOWERS PERRIN, VALHALLA, N.Y.

Mr. PICKLE. Now, we will hear from James Durfee. Mr. Durfee.

Mr. DURFEE. Thank you. I am Jim Durfee, an actuary with Towers Perrin. I am here on behalf of the Association of Private Pension and Welfare Plans. As you know, APPWP is a nonprofit organization whose members include large and small plan sponsors and organizations providing support services to plans, such as banks, insurance companies, consulting and actuarial firms, investment firms and other professional benefit organizations.

The members of APPWP overwhelmingly are sponsors of well funded pension plans and, accordingly, we take seriously the need for reforms that ensure that all plan sponsors adequately fund their plans to meet their obligations to workers and retirees.

In reviewing the legislative proposals to improve pension funding and strengthen defined-benefit plans, we are guided by five principles. The first is that we feel strongly about the need for stricter funding requirements for severely underfunded plans. Current law is current is proving inadequate to increase plan funding over a reasonable period of time. In our view, Congress needs to be careful not to provide transition rules that are so generous or exceptions that are so large that they cancel the ameliorative effects of any new rules.

Our second principle is that plan sponsors with well-funded plans should not be required to pay any more than they are now paying to the PBGC insurance system. We strongly oppose any change in the flat rate portion of the PBGC premium.

Our third principle is that no legislation should enable the PBGC to thwart normal business transactions solely on account of the PBGC's desire to be more secure in its claims than any other creditor.

Our fourth principle is that we need collectively to pay attention to plant shutdown benefits. The law currently provides rules on how to fund liabilities for such benefits after a triggering event occurs. We need to at least explore the possibility of a separate premium system for these benefits.

Finally, our fifth principle is that this legislation should deal only with issues related to defined-benefit plans covered by the PBGC and not with other benefit rules. The proposed ban on the use of cross testing in demonstrating compliance with nondiscrimination for defined-contribution plans has no place in a PBGC bill.

We have worked with the Treasury Department and the IRS to understand their concerns relating to cross testing and we continue to believe that, if necessary, the nondiscrimination regulations issued by the Treasury Department could be strengthened to address any of their concerns in connection with cross testing.

We like the direction the administration's pension reform bill, H.R. 3396, takes on the minimum funding rules. Our members are pleased to see the elimination of double counting of gains and losses, a solvency contribution, immediate recognition for funding purposes of collective bargaining increases, prohibition of benefit

increases in bankruptcy, and the elimination of quarterly contributions for well funded plans.

We do have some concerns in these areas, however, that we would like to share with our committee, and there are more detailed comments in the written rules, but at this stage, we have concerns, we do applaud the elimination of double counting of gains and losses that results in no extra contribution for badly underfunded plans, but there are other changes that—which concern us.

The first is the restriction of the interest and mortality assumptions, and we are very concerned with placing further restrictions on assumptions. Section 412 already gives them the opportunity to choose reasonable assumptions, and we oppose the continued reduction in that discretion. The need for other changes in this area is unproven.

We are also quite concerned about the proposed transition rules which are needlessly complicated, especially for plans between 75 and 85 percent funded. We would prefer a more straightforward transition rule, such as the rule that previously phased in quarterly contributions or one that permits a cap in the required additional contributions equal to an amount which would increase the funded percentage by 3 percent in each of the transition years.

Other bills, including H.R. 298, which you introduced, Congressman Pickle, would amend the section 401(a)(29) of the code to preclude any benefit increases if a plan is less than 90 percent funded, unless either the benefit increase or the plan's existing underfunding is secured. We commend your concerns about some benefit increases. While we think the 90 percent threshold is too high, the current 60 percent threshold, with a less exemptive transition rule than in the current statute, may well be a good approach to protecting new benefit increases in underfunding plans. Any such change, however, needs to be concerned with new plans that recognize employees' past service.

Finally, in section 407 of the bill, we strenuously object to the concept of tinkering with the rounding rules for qualified plan CPI adjustments solely as a revenue raising gimmick. A poor precedent was set on this issue last year in the indexation of the section 401(a)(17) pay cap. Congress should resist further temptation in this area. Such arbitrary actions are harmful to sound pension policy.

Thank you for the opportunity to testify.

Mr. PICKLE. We thank you, Mr. Durfee.

[The prepared statement follows:]

TESTIMONY
OF THE
ASSOCIATION OF PRIVATE PENSION
AND WELFARE PLANS

BEFORE

THE COMMITTEE ON WAYS AND MEANS
OF
THE U.S. HOUSE OF REPRESENTATIVES

April 19, 1994

Good morning. I am Jim Durfee, an actuary with Towers Perrin. I am here on behalf of the Association of Private Pension and Welfare Plans (APPWP). As you know, the APPWP is a nonprofit organization whose members include large and small plan sponsors and organizations providing support services to plans, such as banks, insurance companies, consulting and actuarial firms, investment firms and other professional benefit organizations. APPWP members sponsor or provide services to retirement and health plans covering over 100 million participants. The members of the APPWP overwhelmingly are sponsors of well-funded pension plans and, accordingly, we take seriously the need for reforms that ensure that all plan sponsors adequately fund their plans to meet their obligations to their workers and retirees. We commend the Ways and Means Committee for holding a hearing to better understand the issues of concern to the Pension Benefit Guaranty Corporation and the nation's pension system.

We recognize the difficulty in balancing the PBGC's concerns about potential liabilities that may become its responsibility and the needs of plan sponsors to address existing problems with as little disruption as possible on the operation and administration of their plans and on their businesses. The efforts to achieve this balance are reflected in the proposed legislation introduced on behalf of the Clinton Administration by Chairman Dan Rostenkowski (D-IL) and Education and Labor Committee Chairman William Ford (D-MI). It is also reflected in H.R. 298, sponsored by Rep. J.J. Pickle (D-TX), Chairman of the Subcommittee on Oversight, who has been a longtime champion of pension funding reform.

In reviewing the legislative proposals to improve pension funding and strengthen defined benefit plans, we are guided by five principles. The first is that we feel strongly about the need for **stricter funding requirements for severely underfunded plans.** Current law is proving inadequate to increase plan funding over a reasonable period of time. In our view, Congress needs to be careful not to provide transition rules so generous, or exceptions so large, that they cancel the ameliorative effects of any new rules.

The second principle is that **plan sponsors with well-funded plans should not be required to pay any more than they are now paying** to the ERISA Title IV insurance system. Simply put, we would strongly oppose any change in the flat rate portion of the PBGC premium.

The third principle is that **no legislation should enable the PBGC to thwart normal business transactions solely on account of the PBGC's desire to be more secure in its claims than any other creditor.** We believe that the PBGC's ability to impose liability under Title IV on predecessor controlled group members provides sufficient protection, and that the grant of additional powers they seek are unwarranted.

Our fourth principle is that we need, collectively, **to pay attention to plant shutdown benefits** -- the so-called

unpredictable contingent event benefits. The law currently provides rules on how to fund liabilities for such benefits after a triggering event occurs, on the theory that both from a calculation and revenue standpoint, these benefit liabilities cannot be funded in advance. We need to at least explore the possibility of a separate premium system for these benefits.

Finally, our fifth principle is that **this legislation should deal only with issues related to defined benefit plans covered by the PBGC insurance system, and not with other benefit rules.** The proposed ban on the use of cross-testing in demonstrating compliance with the nondiscrimination requirements for defined contribution plans has no place in a PBGC bill. We have worked with the U.S. Treasury Department and the Internal Revenue Service to understand their concerns relating to cross-testing. We continue to believe that, if necessary, the nondiscrimination regulations issued by the Treasury Department could be strengthened, to address any concerns over the practice of cross-testing **without eliminating age and service weighted plans.**

We like the direction that the Clinton Administration's pension reform bill, the **Pension Protection Act**, H.R. 3396 takes on the minimum funding rules. Our members are pleased to see the elimination of double counting of gains and losses, a solvency contribution, immediate recognition for funding purposes of collective bargaining increases, the prohibition of benefit increases in bankruptcy and the elimination of quarterly contributions for well-funded plans. However, we do have some concerns in this area that we would like to share with the Committee.

While we applaud the elimination of double counting of gains and losses that often results in no extra contribution, or only a token extra contribution, for badly underfunded plans, the proposal would make three other changes to the deficit reduction contribution all of which concern us. The first is to require the use of an interest assumption for current liability purposes that is between 90% and 100% of the interest rate corridor, rather than between 90% and 110%. The second is to require the use of a standard mortality table. The third is to change the percentage formula in Internal Revenue Code Section 412(l) to speed up funding of post-1987 unfunded liability. With respect to the first two items, we are very concerned with placing further restrictions on actuarial assumptions. Section 412 gives the enrolled actuary the obligation to choose reasonable assumptions, and we oppose the continual reduction in that discretion. The need for the third change is unproven, especially if the other changes are made.

We are also quite concerned about the proposed transition rule, which we find needlessly complicated, especially for plans between 75% and 85% funded. We would prefer a more straightforward transition rule, such as the rule that previously phased in quarterly contributions, or one that permits a cap in the required additional contributions equal to an amount which would increase the funded percentage of the plan by 3% in each of the transition years. On the other hand, it will help neither the financial condition of the PBGC nor American businesses if the transition rules are not carefully targeted to strike a balance between better funding and economic viability of the plan sponsor. It is important for the APPWP to better understand the rationale of the transition rules, and strike this balance, in order for us to support the bill.

In the funding area, the bill would also add a solvency contribution to ensure that there are always sufficient assets to pay at least three years of benefit payments. We are not convinced that three years of payments is necessary. We have seen nothing that would indicate that two years of payments would

be inadequate. In addition, the solvency requirement is very complicated. We are not in disagreement with the concept, but the drafting seems very cumbersome, and the penalty scheme seems like overkill. In our view, it unnecessary to impose, for failure to meet the solvency rules, the Internal Revenue Code Section 4971 excise tax, a civil penalty, and a restriction on other payments of benefits. Finally, we particularly object to the requirement that makes a plan look back on a quarterly basis for calculations. This requirement alone creates significant administrative burden with no ameliorative effect that we can discern.

We applaud the elimination of quarterly contributions for well-funded plans and suggest that the PBGC also explore exempting small plans from the requirement. In our view, this bill is correctly focused on plans that represent large potential losses to the PBGC. In that spirit, plans which do not present that risk should be exempted from the quarterly contribution requirement.

We are also pleased to see some reductions in the Internal Revenue Code Section 4972 excise tax, but ask again for Internal Revenue Code Section 404(g) to be amended as well, so that the final employer contribution required to complete a standard plan termination would always be currently deductible. In addition, we believe that the Section 4972 changes do not go far enough. They exempt nondeductible matching contributions from the excise tax, but not discretionary contributions that have been promised to employees, either in collective bargaining or by consistent practice. We believe that such contributions should be both deductible and exempt from the section 4972 excise tax.

Sponsors of other bills, including Oversight Subcommittee Chairman J.J. Pickle's bill, H.R. 298, have suggested that Internal Revenue Code Section 401(a)(29) should be amended to preclude any benefit increases if a plan is less than 90% funded, unless either the benefit increase or the plan's existing underfunding is secured. We commend Congressman Pickle's concerns about such benefit increases. While we think the 90% threshold is too high, a 60% threshold, with a less exemptive transition rule than in the current statute, may well be a good approach to protecting new benefit increases in underfunded plans. Any change to section 401(a) (29), however, needs to be concerned with new plans that recognize employees' past service. Many ill advised policies of recent years have threatened the formation of new defined benefit plans. The absence of a transition rule for new plans would further constrict plan formation.

One final note in the funding area: in later years, even for well-funded plans, the aggregate effect of these new rules would be to create or increase contribution volatility, solely on account of changes in the market value of the assets. We would like to work with the Ways and Means Committee to develop some cap on short term swings in contribution requirements that are caused by market changes. Among our members, one of the most frequent complaints about the rules governing defined benefit plans is the volatility of the contributions. If we are to continue to form and maintain defined benefit plans, we cannot ignore this issue.

H.R. 3396 makes a variety of reporting and administrative notice changes that are acceptable, by and large, although we need to make sure that the administrative burden they place on plans is warranted in terms of risk to the PBGC. Section 201 of the bill deals with reportable events. With respect to the prospective notification events, we believe that requiring a determination of a plan's funded status using the artificially low PBGC variable rate premium interest rate pulls in too many

plans. We suggest, instead, the use of the Internal Revenue Code Section 412(l) current liability definition. We believe that new reportable events should be limited to plans that have more than $1 million in unfunded vested benefits, much as the current reportable events regulations limit notification of almost every reportable event only to significantly underfunded plans. We see no reason not to put such a threshold into the law, rather than into regulations. Finally, in our view, new events (11) and (12) are too broad and give the PBGC too much discretion.

We are very troubled by section 202 of the bill. We think it gives far too much discretion to the PBGC to interfere with normal business transactions. If the PBGC wants authority to obtain additional equitable relief other than termination or trusteeship, current section 4042(b)(2) of ERISA could be amended to permit the PBGC to seek other equitable relief if the tests in section 4042(a) are met. Similarly, nothing in the statutory language of H.R. 3396 convinces us that section 204 of the bill, dealing with liquidation of a controlled group member, is a good idea. It requires all plan underfunding to be claimed against a liquidating controlled group member, even if the plans are not terminating and even if the remaining controlled group members are strong. In addition, we find the concept of assignment of claims to be curious. The PBGC may need some relief in this area, but this section is drafted too broadly and allows for completely inequitable results.

We strongly oppose the provision that would allow the PBGC to enforce the Internal Revenue Code Section 412 minimum funding requirements. We believe that joint administration is confusing, inconsistent and unworkable. Joint administration has been unsuccessful in the past. ERISA originally vested enforcement responsibility in the Labor Department and the Internal Revenue Service. After a three year period between 1975 and 1978, those agencies agreed that joint administration was unworkable. We believe that closer interagency coordination would work better than joint administration.

The bill gradually removes the cap on the variable rate premium, a change that we had suggested. We feel, however, that there should be a delayed effective date for this provision, to allow the strengthened funding rules an opportunity to reduce the number of plans that would be subject to the uncapped premium. The bill would also eliminate any notice period before the PBGC can perfect its lien under section 412(n). While 60 days, as provided under current law, may be too long, no notice period is harsh. A shorter period would be acceptable, such as five days from the date the PBGC notifies the plan sponsor of a missed contribution.

In other areas, the bill requires amounts allocable to missing participants to be paid to the PBGC, which would undertake the responsibility for the benefit. We would prefer that this provision be optional. Also, we object to section 303 of the bill, which increases the guarantee for disability benefits. We do not understand the expansion of guaranteed benefits, regardless of how sympathetic the case, when the PBGC is requesting increased variable rate premiums just to pay currently guaranteed benefits.

In section 405 of the bill, we are concerned with the mortality table chosen, since it appears to reference a sex distinct group annuity valuation standard. In addition, while the change in interest rates is welcome, the rate of interest on 30-year Treasury securities changes often and would be an administratively difficult standard to use. For the sake of simplicity and consistency, we suggest that the statute be written to permit a plan to use the 30-year Treasury rate as of

the beginning of the plan year for benefits paid during the entire plan year.

In section 407 of the bill, we strenuously object to the concept of tinkering with the rounding rules for qualified plan Consumer Price Index adjustments solely as a revenue-raising gimmick. A poor precedent was set on this issue last year in the indexation of the Internal Revenue Code Section 401(a)(17) pay cap, and Congress should resist further temptation in this area. Such arbitrary actions are harmful to sound pension policy.

Thank you for the opportunity to testify today. I would be happy to respond to any questions you may have.

STATEMENT OF PAULA A. CALIMAFDE, CHAIR, SMALL BUSINESS COUNCIL OF AMERICA

Mr. PICKLE. Now, we go to Paula Calimafde.

Ms. CALIMAFDE. Mr. Chairman and members of the committee, I am Paula Calimafde, the chair of the Small Business Council of America, and I am also a practicing attorney who specializes in retirement plan and employee benefits law.

I am here to present the views of our members on the administration's proposal to ban age-weighted and cross-tested defined-contribution plans, which is unfortunately included in the PBGC reform proposal.

Our members are small businesses who are stable enough to sponsor defined-contribution plans. Unfortunately, most of them cannot afford defined-benefit plans, primarily because the burdens due to the actuarial expenses are just too high these days.

The age-weighted and cross-tested plans are defined-contribution plans which are totally outside the PBGC program and do not in any way contribute to the PBGC financial problems.

We are opposed to this proposal to ban age-weighted and cross-tested plans. Small businesses rely on defined-contribution plans to meet the retirement needs of their workers. Many age- and service-weighted plan formulas would be outlawed by this proposal.

I would like to try to answer the question—why has the PBGC legislation, which is primarily dealing with defined-benefit plans, provoked so much controversy in the small business area? The answer is because of this banning of the age-weighted and cross-tested retirement plans.

A defined-contribution plan has individual account balances. They are fully funded every year. The 401(a)(4) regulations allows defined-contribution plans to test the discrimination of those plans on a benefits basis. This allows age to be taken into account.

So a smaller contribution for a younger employee when projected to retirement age is equivalent to a larger contribution for an older employee because there are fewer years for that older employee to reach retirement age. This is very similar to insurance policies where insurance for someone who is 30 is cheaper than insurance for someone who is 56 years old. It is also true that goes on in the defined-benefit world and also in the target benefit world.

We have heard that the Treasury officials believe that the age-weighted, cross-tested plans do not provide the same protections as defined-benefit plans would. We assume they are referring to PBGC coverage, but that is more or less irrelevant because you cannot have an underfunded age-weighted or cross-tested plan. It is possible they are referring to the fact that investments—investment yield is guaranteed in a defined-benefit context, and that is true.

With a defined-contribution plan, you will only get the interest actually earned on that account. Generally speaking, that interest is the same, if not better, than in a defined-benefit plan. However, there is a major difference between defined-contribution plans and defined-benefit plans in the small business context, which is under a defined-contribution plan, employees are not cut back for the length of service they are with that employer. Unfortunately, small

businesses are more than happy to have employees stay with them a long time, but most often that is not the case.

So it is quite possible that an employee who is in a small business with a cross-tested or age-weighted plan will actually have larger benefits than they would get in a defined-benefit plan, primarily because they would not be staying necessarily to retirement.

I want to say a quick word about top-heavy plans since they are considered to be "bad plans." Unfortunately, 80 to 90 percent of all privately held companies' plans are top-heavy plans. That doesn't seem to be understood. It is because of a mathematical test, and basically privately held companies are usually leaner and meaner than larger businesses and therefore the owner, key employee to nonkey ratio is higher than you would find in larger business.

Because of the mathematical test, in fact, we are going to find a lot of companies with 100, 200, 300 employees are going to be sliding into a top-heavy type of situation which probably was never contemplated under the statute to begin with, but let me assure you, top-heavy plans do provide valuable benefits for all employees, highly compensated or not, and that is because of all the safeguards in the system. They have been placed there carefully over the last 10, 10 years I would say, and they work.

Now, you might say, well, why is small business upset about what just happened in the PBGC bill? The reason why is the IRS regulations under section 401(a)(4) took 4 years to come about. They have been issued in proposed form, in final, reproposed and in "final" final form.

They were discussed fully at American Bar Association meetings, ASPA meetings, IRS roundtable meetings, where the same provisions on dealing with benefits, testing for benefits and nondiscrimination basis were never changed over that 4-year period.

Now, the Under Secretary of Treasury, as you know, criticized these plans on September 30, 1993 and said they should be eliminated, just a month after he had signed off on these regulations. Two days before this press release, IRS said they were going to open up the ruling process on these plans.

So you can imagine a lot of privately held companies are somewhat upset that plans that they have worked on for over 4 years are, within a matter of weeks, deemed to be abusive. Plus it costs a lot of money to set up these plans, and IRS requires more than $1,000 user fee to approve these plans. So—and the smaller the business, those kind of numbers aren't peanuts.

Now, the other thing is people keep talking about age-weighted and cross-tested like they are the same thing. They are not. There is simply no such thing as an abusive age-weighted plan and I would issue a challenge to anyone at Treasury to show me an age-weighted plan that is abusive.

I am sure you could come up with cross-tested plans that are abusive. On the other hand, they can be used for terrific results where you are comparing different divisions, you are giving employees with more service greater benefits, that type of thing. So it is a very good plan.

I also want to point out that there is a coalition to preserve profit sharing flexibility and they have come up with a compromise where every—excuse me—top-heavy plan would give a 5 percent base con-

tribution for any plan that wants to go into cross testing, and we support that coalition and that compromise.

Thank you.

Mr. PICKLE. Well, I thank you very much for your testimony.

[The prepared statement follows:]

STATEMENT OF PAULA A. CALIMAFDE ON BEHALF OF THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE WAYS AND MEANS COMMITTEE of THE U.S. HOUSE OF REPRESENTATIVES

ON AGE WEIGHTED AND CROSS TESTED RETIREMENT PLANS

April 19, 1994

Mr. Chairman and Members of the Committee, I am Paula Calimafde, the Chair of Small Business Council of America (SBCA). I am also the head of the retirement plan and employee benefits department of one of Montgomery County, Maryland's larger law firms, Paley, Rothman, Goldstein, Rosenberg & Cooper, Chartered. As Chair of the SBCA, I am here to present their views on the Administration's proposal to ban age weighted and other cross-tested defined contribution plans which is included in the Administration's PBGC reform proposal (HR 3396/S 1780).

SBCA is a national nonprofit organization which represents the interest of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represent well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans.

As a spokesman for small business retirement plan sponsors, we are primarily concerned with defined contribution plans since they are the preferred retirement plan vehicle for privately held businesses. Consequently, we do not offer recommendations on the proposed modifications to the PBGC insurance program. We limit our remarks to the proposed ban on age weighted and cross tested defined contribution plans which by law are totally outside the PBGC program and do not contribute to any PBGC financial problems. We believe that changes to defined contribution plans should not be included in a PBGC/defined benefit bill. There is no rationale for including any changes to defined contribution plans in a bill aimed exclusively at protecting the interests of employees covered by defined benefit plans.

We are opposed to this proposal to ban age-weighted and cross-tested plans. Small businesses overwhelmingly rely on defined contribution plans to meet the retirement needs of their workers. Many use age and service weighted plan formulas which would be outlawed by the Administration's proposal.

The SBCA believes that employers should be able to continue sponsoring cross-tested and age weighted defined contribution plans. We do not share the Treasury view. Indeed, by its own admission the Department has no hard evidence that these plans are being utilized in an abusive manner (indeed plan sponsors are following IRS regulations) and has allowed that its proposed ban of all cross-tested age weighted plans is not warranted.

First, it must be understood that age-weighted plans are simply not abusive. The technical experts in the SBCA have never seen <u>any</u> abusive situations under these types of plans. The protections designed by the IRS through its regulations, combined with the top-heavy minimum requirements, assure that the interests of all employees are fully protected. In fact, any practitioner skilled in the retirement plan area will quickly concede that the age-weighted plan will give rise to almost identical numbers as a

target benefit plan and similar, if not higher for non-highly compensated employees, numbers to that generated by a defined benefit plan.

IRS Code §401(a)(4) prohibits discrimination in favor of highly compensated employees. This section provides that either contributions <u>or</u> benefits must not discriminate in favor of highly compensated employees. Age-weighted and cross-tested plans comply with IRS developed non-discrimination regulations, which were developed over a period of five years, received significant analyses and input, were drafted, proposed and reproposed several times before being finalized in the fall of 1993.

Testing contributions on a benefits basis allows age to be taken into account. A smaller contribution for a younger employee will provide the same retirement benefit when projected to retirement age as a larger contribution for an older employee. The smaller contribution has more time to grow, so that when projected to retirement age it is equal or greater in value to the larger contribution made for the older employee, which has less time to grow. Thus, when contributions are compared by the retirement benefit they are projected to provide, a smaller contribution for a younger employee is nondiscriminatory. The fact that a contribution was greater for an older person does not mean that the plan discriminated against a younger employee. A simple analogy which involves group life insurance may help explain the process. A $1,000 death benefit may cost an employer $1.00 a year for a 30 year old. The same $1,000 death benefit costs the employer about $10.00 for a 57 year old. The fact that the employer is paying as much as ten times more for the older person does not make the plan discriminatory. The plan is absolutely non-discriminatory because it provides the same benefit to each employee. So it is with qualified plans. When the benefit provided is the same, the plan is not discriminatory, even though the current year's cost is different.

If there are discriminatory cross-tested plans, then the correct solution is to redesign the qualifying test rather than prevent employers from using a plan technique that has made it possible and feasible for many small businesses to offer a retirement plan. While curbing abusive tax practices is a legitimate objective, as or more important are the objectives of fostering retirement income and long term savings. Micromanagement and additional changes in the law are counterproductive to these desirable goals.

SBCA notes that it is the experience of its practitioner members that where it is possible to design cross-tested plans to result in wide disparities between highly and non-highly compensated employees, most employers are unwilling to adopt such a plan. Rather, the plans are used not only to provide a vehicle for significant retirement savings, but also to provide a legitimate and valuable employee benefit. The existing rules work quite well to achieve that result.

Recent examples of actual cross-tested plans show how desirable these plans can be. A high technology company which produces software has just become stable enough to provide retirement benefits for its employees. The company started in 1984. The company did not want to become involved with a defined benefit plan because of the high administrative and actuarial expense involved. At the same time it did want to benefit its loyal long term employees particularly because loyalty is not a

given in this industry. The company adopted a cross-tested plan which had two groups - employees hired before 1984 and those hired after 1984. The employees hired before 1984 received a 14% contribution, those hired after received a 7% contribution. This plan suited the goals of the company and all employees received a significant retirement benefit they had not received before.

Another company, a large incorporated law firm, set up three different groups - the first for all employees who are over the age of 50, the second group for employees except associate attorneys who are under the age of 50 and the third group for associate attorneys who are under the age of 50. The first group is to receive a 12% contribution, the second group is to receive an 8% contribution and the final group receives a 3% contribution. Again, this plan suited this company better than other type of plan available to it. This plan certainly does not appear to be abusive....

There are many options available to companies who are willing to come under the auspices of the 401(a)(4) regulations. For instance, different divisions can be given different plan formulas, different groupings of employees, based on service, age or type of job, can be given varying percentages, additional contributions can given to employees who exceed certain production goals, etc., etc. - as long as the complex, and carefully constructed guidelines of the 401(a)(4) regulations are followed. These are decent goals and there use should not be curtailed by a reaction that only defined benefit and target benefit plans should be allowed to assist older employees.

While Treasury Department officials have admitted that the proposed ban was an over-reaction, the dilemma they created continues to work a severe hardship on small plan sponsors who have elected to use an age or service weighted benefit formula. It has also dissuaded or discouraged many potential small business plan sponsors from adopting a retirement plan that gives credit to age or service.

Defined benefit plans which by their very terms assist older employees, realistically cannot be sponsored by small business. Many companies, particularly mid-size or smaller, who would provide larger benefits for their older employees, now shy away from defined benefit plans. Among the reasons are extraordinarily high administrative costs and complexity. These additional burdens and complexity have been added by Congress and IRS over the last ten years.

Therefore, our request of the Ways and Means Committee is to work with cross-tested plan sponsors to help convince the Administration to either officially abandon the repeal of the age-weighted and cross tested plans, or agree upon a mutually agreeable alternative for curbing aggressive use of cross-testing plans. The Coalition for Profit Sharing Flexibility has come up with a compromise which is fair and simple, which we can endorse wholeheartedly.

The SBCA is a part of a coalition for Profit Sharing Flexibility which literally includes every major retirement plan group save ERIC (The ERISA Industry Committee) and APPWP (Association of Private Pension & Welfare Plans). Other groups which belong to the Coalition are the American Council of Life Insurance (ACLI), the American Society of Pension Actuaries (ASPA), the Association for Advanced Life Underwriting (AALU), Employee

Benefits Policy Association, Employers Council on Flexible Compensation (ECFC), the National Association of Life Underwriters (NALU), the National Association of Manufacturers (NAM), the National Federation of Independent Business (NFIB), the National Institute of Pension Administrators (NIPA), the Profit Sharing Council of America and the U.S Chamber of Commerce. This coalition has come up with a fair and workable compromise.

As mentioned above the final IRS regulations clearly endorsed the "age-weighted" and other "cross-tested" plans and set forth a road map for companies to follow so as to demonstrate nondiscrimination. Over the last four years, these regulations have been issued in proposed, final, reproposed, and finally, final form with the IRS and Treasury being fully aware of these provisions and how they operate. At each stage the rules for determining whether a defined contribution plan is nondiscriminatory on a benefits basis have remained essentially the same. A senior Treasury Official criticized these plans at a press hearing held on September 30, 1993 and proposed eliminating them. This same official had signed off on these 401(a)(4) regulations which explicitly allow age-weighted and cross-tested plans, less than a month before. Indeed, two days before the press statement criticizing the plans, IRS had announced that it would begin approving individually designed age-weighted and other cross-tested plans (September 28, 1993). Accordingly, the PBGC legislation included language prohibiting these plans. This legislation provides that defined contribution plans (other than target benefit plans) can only be tested for nondiscrimination on the basis of contributions and not benefits. The effective date for this ban on these plans is for plan years beginning after September 30, 1993, except for plans that were in existence on that date, the effective date is for plan years beginning in 1995. Questions still remain as to the meaning of the effective date - some experts claim that if there was any plan in existence on September 30, 1993 (not necessarily a cross-tested plan) that the transitional date applies, not the outright elimination.

Privately held companies who had adopted these individually designed plans discovered that what had been set forth by the regulations for more than four years had within a matter of days been deemed "abusive" and legislation had been introduced to eliminate the newly established plans. Understandably, companies large and small which had paid money to advisors to establish these plans and/or work out the numbers to make sure they fell within the parameters of the legislation are extremely concerned.

The coalition compromise requires a top-heavy plan that is using the 401(a)(4) regulations to test a defined contribution plan for nondiscrimination on a benefits basis to give a minimum 5% contribution to any non-highly compensated employee. Now this compromise is not perfect, particularly because it singles out businesses which are privately held for greater burdens by requiring extra contributions for those who fall within the top-heavy rules. And there is no question that a hike from 3% to 5% is a major price to pay to enter the world of the 401(a)(4) regulations, particularly when larger businesses have no such road blocks. But despite these real criticisms, this is a compromise that the coalition could endorse primarily because of its inherent simplicity. It is so important for simplicity to begin to reign supreme in the retirement plan area.

THE CRISIS AHEAD

Last year, the National Institute on Aging (NIA) reported that millions of Americans in their 50s face an uncertain future, lacking health insurance or pensions, or fearing that they will lose the benefits they do have. The survey by NIA found that a substantial number of people -- especially minorities -- lack pension coverage that may rob them of a satisfying and successful retirement.

The findings, while shocking, do not come as a surprise to benefits professionals. Most of us are aware that in recent years the focus of America's retirement and employee benefits policy has shifted dramatically for the worse. Those of us concerned about the viability of the private benefits system know all too well that the budget deficit and not retirement and savings objectives, has driven almost all debate on important national issues, including retirement matters.

In March of 1993, the American Academy of Actuaries reported that since 1988 at least 50,000 of America's small business firms -- those with less then 25 employees -- have eliminated their defined benefit pension plans leaving their workers without retirement plans. An equal number of small firms, according to the Academy, chose to replace their defined benefit plan with a defined contribution plan. The Academy's data is confirmed by the U.S. Department of Labor which reported in its initial Private Pension Bulletin that defined benefit plans had decreased by 24% between 1983 and 1989. The DOL reported that the trend shows that we are no longer seeing a growth in the number of plans nor is the percentage of the workforce with pension plans growing. Indeed, while the workforce grows, the percentage of covered workers falls (albeit, there was a small increase in 1992).

This drop in pension plan coverage couldn't come at a worse time. The graying of America, and the burden that it will place on future generations, can not be ignored. The American Council of Life Insurance reports that from 1990 to 2025, the percentage of Americans over 65 years of age will increase by 49%. This jump in our elderly population signals potentially critical problems for Social Security, Medicare and our nation's programs designed to serve the aged.

While we must assure our citizens that Social Security and Medicare will remain strong and stable, private pensions, savings and private sources for retiree health care will have to play a more significant role for tomorrow's retirees. The savings that will accumulate for meeting this need will contribute to the pool of investible capital that will provide the economic growth needed to finance the growing burdens of Social Security and Medicare. But such savings won't be forthcoming in the face of the kinds of policy directions reflected by the Administration proposal.

THE TWO CAUSES OF THE CRISIS

While many factors can be cited for the crisis, two stand out --DIMINISHING TAX INCENTIVES and INCREASED COSTS DUE TO OVERREGULATION. The loss of tax incentives appears to be directly related to our nation's budget deficit problems. Reducing the tax incentives for pensions is destructive of our goal of having an adequate retirement savings system.

Frequently, the case for reducing the incentive is premised on dubious assumptions that the current incentives are not functioning as expected. Oftentimes, advocates for reducing tax incentives

employ the politics of envy. Both the Association of Private Pension Plans and the Employee Benefits Research Institute have recently published treatises that punch holes in the logic of those advocating reduced tax incentives for retirement savings. While defending current tax incentives is commendable, what's really needed are new tax incentives to overcome the losses of the past decade.

We are not advocating that pension and employee benefit tax incentives should be designated as too sacred to touch. What concerns us is that the reviews and evaluations are hasty and seldom subject to adequate public input. Efforts to raise opposing views are subjected to budgetary points of order and saddled with the burden of proposing alternative revenue sources if the questioned policy change is to be removed from the revenue package. This violates the American sense of fair play. We ask simply that someone speak out against what we see as a patently biased approach to setting public policy.

The other factor that is contributing to the stagnation of private pension and welfare plans is the unrelenting drive to suffocate our private benefits system with questionable costs due to increased burdens imposed by regulation. In the above mentioned American Academy of Actuaries study the reason most often given for abandoning a pension was the growing burden to comply with government regulation. Nearly 60% of small employers in the Academy's study cited the cost of compliance as the primary reason for their decision to terminate a defined benefit plan. Almost 30% of large firms cited this factor also.

Despite the increasing evidence that we are drowning employers in regulations, the push for more regulations and laws appears unrelenting while the drive to simplify compliance is locked up in legislative stalemate as is the case for the laudable Pension Simplification Bill (HR 3419) approved by this Committee. The SBCA hopes that the Committee will appreciate the valuable contributions which can be made to our society by allowing the age-weighted and cross-tested plans to flourish and will either legislatively endorse the compromise set forth by the Coalition for Profit Sharing Flexibility or abandon this ill-conceived ban on age-weighted and cross-tested plans.

NEW PLAN COMPARISON - TYPICAL CENSUS SCENARIO

Individual Contributions					Individual Annual Projected Benefits at Age 65		
Age	Salary	Defined Benefit	Age-Weighted Profit Sharing	Cross-Tested Profit Sharing	Defined Benefit	Age-Weighted Profit Sharing	Cross-Tested Profit Sharing
50	$150,000	$23,738*	$27,548	$30,000	$68,928	$64,908	$70,680*
50	40,000	8,630*	7,346	2,400	18,384*	17,304	5,652
45	40,000	5,993*	4,885	2,400	18,384	18,516*	9,096
35	30,000	2,556*	1,621	1,800	13,788	13,980	15,516*
25	20,000	1,083	600	1,200*	9,192	10,884	21,750*
		$ 42,000	$42,000	$37,800			

You can see that all three designs produce similar results. While the 25 year old receives only $600 in the Age-Weighted Pla the projected annual benefit at age 65 of $10,884 is quite good. The age-weighted and cross-tested plans both produce simil plan designs but without the fixed committment of defined benefit plans.

STATEMENT OF VICKI GOTTLICH, STAFF ATTORNEY, NATIONAL SENIOR CITIZENS LAW CENTER, ON BEHALF OF WOMEN'S PENSION POLICY CONSORTIUM

Mr. PICKLE. Now, we have one more witness, Vicki Gottlich, staff attorney for the National Senior Citizens Law Center.

Ms. GOTTLICH. Thank you very much. I am Vicki Gottlich. I am testifying today on behalf of the Women's Pension Policy Consortium. The Consortium is a coalition of three national organizations, the Pension Rights Center, the Older Women's League and my organization, the National Senior Citizens Law Center.

We are committed to preventing poverty among older women by increasing their access to equitable and adequate pension income. H.R. 3396 furthers the Consortium's goals by strengthening ERISA's insurance protections for defined-benefit plans, improving PBGC's services to plan participants, and eliminating certain practices that encourage plan owners to provide disproportionately fewer or even no benefits to lower-paid workers.

The participants' service provisions of H.R. 3396 will increase the security and peace of mind of participants who are worried about the status of their plans and their benefits. Improved disclosure, especially disclosure of information concerning PBGC guarantees, is necessary for participants who are uncertain about the safety of their benefits.

Guaranteeing the maximum amount of disability benefits for younger workers who meet the Social Security definition of disability will insure that this group of vulnerable individuals gets the full benefit protections they need to insure adequate income.

Establishing a mechanism for getting benefits to missing participants of terminated plans will help more former workers and their beneficiaries receive the benefits they earned.

Finally, we truly appreciate that the PBGC chose not to reduce the levels of its benefit guarantees for participants. The PBGC thus assures participants that they will not further bear the burden of improper funding decisions made by plan sponsors.

We would like to concur in the written testimony of the American Association of Retired Persons. In their statement, they point out the need to guarantee annuities purchased on the termination of plans to avoid the situation of the Executive Life Company.

We encourage Congress to consider ways to provide PBGC to see guarantees in this situation.

I would like to focus the rest of my comments on behalf of the Consortium on a different point, the age-weighted and cross-testing issue that we talked about today so much.

It is important to remember that these plans are new, having grown out of the recent 401(a)(4) nondiscrimination regulations. Before these plans came into existence, there were other types of plans that small employers could use to promote the needs of their employees and themselves for retirement income.

I want to point out the existence of the Simplified Employees Pension Plan, or the SEPP, which is an inexpensive and very simple way of establishing a plan for small employers. In fact, there is one kind of SEPP that allows employers to establish what is in essence a 401(k) in which they themselves do not even have to make contributions.

These are simple. These are open to all employees and they are not costly. They also are not discriminatory. Age-weighted and cross-testing plans allow sponsors to provide greater benefits to older, more highly-paid owners and key employees at the expense of their younger and less-well-paid workers.

The theory behind the new plans is that older workers have less time to save for retirement than their younger colleagues. The reality is that the older workers are the owners of the business and a few better-paid employees. Age-weighted and cross-tested plans do not treat employees fairly. They deny access to equitable and adequate pension income for many workers.

More importantly, we are concerned that they encourage employment discrimination against older workers who become too costly to employ because the allocations to their pensions exceed the expectations of the employer. One need only read the numerous articles cited by Assistant Secretary Samuels in his testimony about these plans to understand their pernicious effect. Each article is up front and open about the impact of these plans. They are described as tax-planning devices. They are compared favorably to nonqualified plans. In some of the examples, employers using the new plans can go from an allocation of 62 percent of contributions to the owner and two top employees to 85 percent of allocations.

Who are the lower paid workers who lose pension benefits under these plans? The businesses in the articles praising these plans refer to them by their jobs, secretaries, receptionists, clerks, technicians and support personnel. These are jobs traditionally occupied by women.

The proliferation of these plans may cause older women to lose jobs and job opportunities just at a time when they need to enter the work force. Employers are being advised that these plans are not as effective in diverting benefits to the owner if the work force is older. The employer may have to pay more to an older, nonkey employee.

A comment in the Wall Street Journal sums this up. It says, "Hiring an older person becomes more expensive and the plans give employers an incentive to discriminate against older workers."

My testimony contains statistics about the impact of a lack of a retirement plan on older workers. I would urge you to look at that, the cross-tested and age-weighted plans do not solve this problem, they cause an increase of defined-contribution plans that provide benefits at the expense of benefits to lower-paid workers. That is not what our tax system is supposed to do.

Our pension policy is to use tax incentives to maintain a voluntary pension system that provides retirement income for a wide range of workers, regardless of their income and job classification. The elimination of cross-tested and age-weighted plans will further this goal.

Thank you for the opportunity to testify.

Mr. PICKLE. Well, I thank you for your testimony and for the testimony of each one of the panelists.

[The prepared statement follows:]

TESTIMONY OF VICKI GOTTLICH
ON BEHALF OF THE WOMEN'S PENSION POLICY CONSORTIUM
BEFORE THE WAYS AND MEANS COMMITTEE
April 19, 1994

Thank you for the invitation to testify today. The Women's Pension Policy Consortium is a coalition of three national organizations, the Pension Rights Center, the Older Women's League, and the National Senior Citizens Law Center, committed to preventing poverty among older women by increasing their access to equitable and adequate pension income. We support the Retirement Protection Act of 1993, H.R. 3396, because it furthers the Consortium's goals in three ways: It strengthens ERISA's insurance protections for defined benefit plans. It improves Pension Benefit Guaranty Corporation (PBGC) services to plan participants. It eliminates certain practices that encourage plan owners to provide disproportionately fewer (or even no) retirement benefits to lower-paid workers.

We focus our comments on this last point, the elimination of "age-weighted" and "cross-tested" profit-sharing and defined contribution plans. Precluding the establishment of "age-weighted" and "cross-tested" plans will improve access to equitable and adequate pension income for women workers who are generally segregated in lower-paying, non-key positions. It will also protect older women who become too costly to employ as a result of these plans from experiencing age discrimination in employment.

Elimination of Age-Weighted Plans

The proliferation of age-weighted and cross-tested profit-sharing and defined contribution plans is a by-product of the Internal Revenue Service's (IRS) regulations under § 401(a)(4) of the Tax Code. The § 401(a)(4) regulations consist of a series of final and proposed regulations designed to promote nondiscrimination in retirement benefits. In contrast, the provisions concerning age-weighing and cross-testing allow plan sponsors to provide greater benefits to older, more highly paid owners and key employees at the expense of their younger and less well-paid workforce. The theory behind this sanctioned discrimination is that older workers have less time to save for retirement than their younger colleagues. The reality is that the older workers in these plans are the owner of the business and a few better paid employees who are more likely to have other resources (including, in the case of the owner, the business itself) than lower-paid workers for whom less is being allocated to retirement savings.

Under the new regulations, defined contribution plans, and most particularly profit-sharing plans, can employ practices similar to those used by defined benefit plans.[1] They can use age-weighted formulas to allocate greater employer contributions to older employees than to similarly compensated younger employees. In determining how much of the employer's contribution will be allocated to each employee, factors that include the age of the employee are taken into consideration. Age-weighted plans pass the contributions or benefits testing requirements of § 401(a)(4) because, when the allocations are

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[1] The Women's Pension Policy Consortium also opposes the use of age-weighted and cross-tested formulas in defined benefit plans for the reasons discussed in the testimony. H.R. 3396 only addresses defined contribution plans, however, we hope the Ways and Means Committee will turn to the examination of these practices in defined benefit plans and to the use of integration practices once they have completed work on this bill.

converted to equivalent accrual rates, the equivalent accrual rates tend to be similar for all participants.

Defined contribution plans can also be tested under the average benefits percentage test of § 401(a)(4). In simple terms, plans may pass this test if the actual benefit percentages for non-highly compensated employees are 70% of the actual benefit percentages for highly compensated employees. Rather than allocating contributions using an equivalent accrual rate formula, these plans have two or more contribution formulas. The first formula provides a minimum contribution for all employees. The second uses factors such as age, years of service, compensation, and class of employees, that allow the plans to allocate additional amounts to highly compensated employees.

Age-weighted and cross-tested plans are particularly attractive for small employers with few highly compensated employees. When small employers use formulas favoring the highly compensated, they can allocate a disproportionate share of the benefits to themselves and to only a few selected employees. There also tend to be larger gaps in both age and compensation between the older, highly-paid owner and the younger, lower-paid work force in small plans. Again, both the age and compensation gaps allow the owner-employer to receive a larger portion of the benefit allocation than the rest of the workforce.

Age-weighted and cross-tested plans are not so attractive where the workforce is large enough to make the testing costly, and where the age disparity between highly paid and non-highly paid workers is not significant. As several pension plan advisors have noted, plans may also encounter trouble if there is high turnover. They advise that the employer runs the "risk" of employing an older worker who receives too large an allocation under the formula being used, necessitating a change in the plan formula.

One need only read the numerous articles published over the past year in business and pension newspapers and journals that extol the virtues of age-weighted and cross-tested plans to understand their pernicious effect. Each article is up-front and open about the impact of these plans on the benefit allocations for rank and file workers. For example, David Wray, president of the Profit Sharing Council of America, described these plans in the Wall Street Journal (Monday, August 16, 1993, p. C 9) as "...tax planning devices ... put in because <u>one person</u> want[s] to defer as much salary as possible." (Emphasis added.) A pension advisor quoted in an article by Donald Jay Korn in the June, 1993, issue of <u>Strategic Planning</u> compares the new plans to non-qualified plans. He states directly that owners get tax advantages while still retaining the ability to select which employees get the most benefits.

As another example, Michael E. Lloyd and Mark K. Dunbar explain in the <u>Journal of Pension Planning & Compliance</u> how the new regulations allow employers to increase allocations to their own accounts. They describe a hypothetical business with ten employees, which, under a plan with a uniform formula, allocates 62% of contributions to the owner and two top employees. Utilizing one of the new formulas, the same business can allocate as much as 85% of contributions to these three employees. The owner then need allocate only 15% of contributions to the other seven employees. The down-side of the new plans, according to Lloyd and Dunbar, is that an employer with older non-highly compensated employees may have to "... provid[e] a benefit to such employees that is larger than intended."

Age-weighted and cross-tested plans contradict every pension policy and goal established by the Department of the Treasury, by the Department of Labor, and by Congress. They in effect reduce the retirement benefits for rank and file workers, who are less

likely to have other retirement savings, while increasing retirement savings for owners and highly compensated employees. Contrary to current tax policy, these plans give employers tax breaks for pension plans from which only they and a few of their high paid colleagues benefit. They are no more than a tax shelter for employers who claim to be providing a retirement benefit for their employees.

Who are the lower-paid workers who lose pension benefits under age-weighted and cross-tested plans? The hypothetical businesses in many of the articles praising these plans refer to them by their job descriptions: "secretaries," "receptionists," "clerks," "technicians," and "support personnel."[2] These are jobs traditionally occupied by women.

It is not just younger women workers who will be disadvantaged through the loss of retirement benefits. The proliferation of age-weighted plans may cause older women to lose jobs and job opportunities. As noted earlier, employers are being advised that these plans are not as effective in diverting benefits to the owner if the workforce is older. The employer may have to pay more to an older, non-key employee than desired, or may have to change the pension formula if an older worker is hired. Harry Conaway, a principal at the benefits consulting firm of William M. Mercer, Inc., commented to the Wall Street Journal, "It makes hiring an older person more expensive." "Small Plans Turn Retirement Plans Into Owners' Gain," Wall Street Journal (Aug. 16, 1993). Donald Jay Korn bluntly says, in discussing a hypothetical in which a 60-year old clerk receives a larger than anticipated contribution under an age-weighted plan, "Many business owners don't like the idea of directing such a large contribution to a non-essential employee." Donald Jay Korn, "Skewed Retirement Plans Help Owners At Workers' Expense," Strategic Planning (June 1993). The business owner who does not want to contribute a large amount to the pension of an older worker will simply choose not to hire older workers or will terminate the positions of those already on staff. According to the Wall Street Journal, "... the plans give employers an incentive to discriminate against older workers."

Thus, older women returning to the workforce after raising a family will not be able to find employment. Older women who are working because their social security is not enough to pay their bills may become too costly to keep on the job if their employer institutes an age-weighted plan. This can have a devastating effect. Older women remain in the workforce because they " .... have less retirement income to fall back on .... while men who have worked in better-paying jobs are able to retire." "Women at Work: The Gap in Wages Is a Function of Ages," Washington Post, D9, 10 (Thursday, April 14, 1994).

The statistics about women, retirement income, and poverty are well known. The risk of poverty for women over age 65 today is 70% greater than for men of the same age. Half of older women living alone have incomes within 150% of poverty. According to the Bureau of the Census, 49% of men over age 65 and only 22% of women over age 65 received income from pensions in 1991. Even those women who were lucky enough to have a pension got less than their male peers. The mean pension income for men was $9,855; the mean pension income for women was $5,186.

The increased number of women in the workforce may not be enough to prevent the younger generation of women workers from

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[2] See, e.g., Donald Jay Korn, "Skewed Retirement Plans Help Owners At Workers' Expense," Strategic Planning (June 1993); David McKeon, "New Opportunities With Age-Weighted Profit-Sharing Plans," Pension World (Oct. 1993); "Retirement Planning," Medical World News (April 1993);

retiring in poverty. An article in last week's Washington Post, cited Census Bureau statistics showing that younger women entering the workforce are now making almost as much as their male peers. "Women at Work: The Gap in Wages Is A Function of Ages," Washington Post, D9 (Thursday, April 14, 1994). The article also reports that as women age, childrearing obligations that influence career decisions, both theirs and those of prospective employers, cause the wage gap to increase. Since pension benefits are a function of wages, women cannot expect to achieve pension benefit equity with men until they achieve pay equity. The continued expansion of age-weighted and cross-tested plans will not improve the position of women in retirement. Rather, it will increase the inequities in both the number of women who will receive a pension and in the adequacy of the amount they will receive.

In short, no good pension policy is served by the continued expansion of the use of age-weighted and cross-tested defined contribution plans. The elimination of cross-tested defined contribution plans by H.R. 3396 is a good first step. It is consistent with the goal of using tax incentives to maintain a voluntary pension system that provides retirement income for a wide range of workers, regardless of their income and job classification.

OTHER PROVISIONS OF H.R. 3396

As noted earlier, the Women's Pension Policy Consortium supports the passage of H.R. 3396. We would like to address briefly other aspects of the bill that strengthen ERISA's insurance protections for defined benefit plans and improve PBGC services to plan participants.

Increased disclosure of information for workers and retirees

We frequently hear from participants who are worried about the funding status of their plans. Some do not know how to determine their plan's financial condition and are concerned about the effect of a plan termination on their pension. They have difficulty understanding the Summary Annual Report (SAR), or the required information is not disclosed on the SAR or is unclear. Others are unaware of the limits of the PBGC's guarantee. When their plan is terminated, they are surprised to learn that the retirement benefits they were receiving are not fully protected.

H.R. 3396 addresses these problems by requiring sponsors of underfunded plans to provide participants and beneficiaries with an annual explanation of the plan's underfunded status. Even more important, the document would also describe the role of the PBGC and explain the limitations to benefit protections. The bill requires the notice to be written in plain, understandable language and to contain information specified by the PBGC.

Missing participant protections

Plan sponsors sometimes have difficulty finding all participants who are entitled to pension benefits upon termination of a plan. Participants who try at retirement to collect the pension they earned at a previous job are sometimes unable to do so because the plan has been terminated and the participants do not know how to proceed. The Internal Revenue Service has instituted a letter forwarding procedure to assist plan administrators, and the PBGC itself has made extraordinary attempts to find missing participants. Yet more is needed to assure that all participants receive the pensions they earned.

H.R. 3396 establishes the PBGC as the repository of pension benefits for missing participants. Employers who terminate plans

would have to transfer to the PBGC adequate assets to cover the benefits of missing participants. Participants who attempt to collect benefits when they reach retirement age - often many years later - can then turn to the PBGC to collect the benefits to which they are entitled.

We would like the Committee to take this protection one step farther. The PBGC should also be required to help participants find missing plans. For example, after a worker leaves her job, the company and its plan might be bought by another company - and sometimes, by other companies after that. When the deferred vested worker attempts to collect her pension, she cannot find the plan because the name of the company and the plan sponsor has changed several times. It would be helpful if the PBGC also kept track of plans of merged and acquired companies so that such deferred vested employees could receive the pensions they earned.

Disability Benefit Protections

Under current law, participants who were disabled at an early age and who are receiving disability benefits are not entitled to full protections for their benefits. The PBGC ceiling on benefit guarantees is reduced because of their age. This can cause a dramatic reduction in income for a group of individuals who, because of their disability, are unable to seek additional work to compensate for the cut in benefits. H.R. 3363 protects the maximum guaranteed monthly benefit for those younger participants getting disability benefits who satisfy the definition of disability for social security disability benefits.

Benefit Protection

H.R. 3396 strengthens benefit protection by requiring those most accountable, i.e., the plans most in danger of termination, to assume responsibility for the costs. By taking this approach, the PBGC is able to ensure its own solvency without having to reduce the level of its benefit guarantees for participants. The PBGC thus assures participants that they will not further bear the burden of improper funding decisions made by plan sponsors.

Thank you for the opportunity to testify.

Mr. PICKLE. To repeat, the Treasury is the one who made these recommendations for changes on cross-testing and on age-weighted plans. They did give us an example this morning.

We are going to ask for other examples and we will look into those two aspects again. I hear your testimony on it, but I think you should realize that this is a strong recommendation of the Treasury and they defended it again this morning.

I also know that ERIC and one of the other witnesses would like to see you not have any benefit increases at all granted in a negotiated settlement unless you put up the money to pay for it. In other words, stop promising it if it isn't funded.

The bill that the administration recommended, with faster funding and the various changes in there, goes a long way to correct that. I am not sure that the committee will stop at that point because I think we are looking at the possibility that perhaps we should increase it even further, but it remains to be seen what the committee wants.

I don't know that we will maintain the 90 percent level that we have supported. That level is negotiable. But, there is some consideration that these plans would, in considering their funding level, include all liabilities, including the pre-1988 liabilities. That lumps them all together. That speeds them up even quicker.

And the question is, how quick can you do it without disturbing plans that are already going? The administration plan would speed it up, no question about that, to between 4 to 7 years, but at least 7 years with a transition rule. So that gives them a little running room.

Now, the question, can you speed it up a little bit more. The subcommittee is going to recommend that we look at it. I don't know that I agree with you that H.R. 3396 just addresses the symptoms of a problem, doesn't cure anything. I think it goes a long way toward improving funding. But, there again, that is something we will have to consider later.

But I do appreciate your testimony for all the people who testified here today. I don't think I have any—oh, I am going to ask, Mr. Kleczka, do you have any questions?

Mr. KLECZKA. No questions, no.

Mr. PICKLE. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Just briefly, Mr. Labedz.

Mr. LABEDZ. Yes.

Mr. MCCRERY. Earlier today, if I heard Secretary Reich correctly, when he was questioned about the best way to prevent companies from overpromising and not being able to keep their promises, he responded that the premium increases and the removal of the cap in the bill was a sufficient deterrent to prevent companies from overpromising.

I presume that you differ with that view and, if so, would you explain why?

Mr. LABEDZ. Sure. We would rather have the additional dollars put into pension funding rather than into PBGC premiums, and one of the steps that he would espouse, eliminating the variable rate cap, puts more dollars into the PBGC instead of into pension funding.

Mr. MCCRERY. But in terms of its deterrence of overpromising, do you have any thoughts on that?

Mr. LABEDZ. We believe that the appropriate way to do it is to match the pension promise with the employer's ability to pay, and that argues for matching it to a funding period rather than to a premium tax.

We think you ought to be able to make an enlightened promise up front if you have got the ability to fund it fast, and we would match the two periods, one to the other.

Mr. MCCRERY. Ms. Calimafde, I saw you shaking your head several times during the testimony of Ms. Gottlich. Would you like to respond to anything she said specifically?

Ms. CALIMAFDE. Boy, would I. Maybe it is because I am a practitioner, so I am involved in the real life issues involving these plans, but what Ms. Gottlich was referring to has to be a cross-tested plan, not an age-weighted plan, you can't get the type of numbers that she is talking about with an age-weighted plan.

Age-weighted plans which are under the 401(a)(4) regulations, contributions are based on age and it is irrelevant whether someone is highly compensated or not. It is just age. You would get similar numbers in a defined-benefit plan and a target benefit plan.

So to say that these plans are somehow more abusive, you just can't get there, from a practitioner's viewpoint.

The cross-tested plan, you can if you are going to say, for instance, that the class that gets higher benefits are the stockholders. But if you were to say that the class who is going to get higher benefits are employees hired after a certain date, then the plan is not abusive. Then what you are doing is you are giving credit to longevity.

Very often different divisions get different percentages, maybe based on where they work. Production can be a type of class. So it is an oversimplification to say all cross-tested plans are abusive, and, yes, there were one or two bad articles out there and there are abusive plans, but I do believe that the coalition's proposal that says a minimum 5 percent is a simple way of getting rid of potential abuse in the world of cross testing.

It is really not needed at all in the world of age-weighting. But Ms. Gottlich put the two kinds of plans together and as practitioner, they are very different.

Ms. GOTTLICH. Mr. McCrery, I would like to respond to that. I agree they are very different plans and the problem when you see a red light going on, is that you sometimes misspeak in your testimony, but as a practitioner and a person who represents participants, I would like to say that I get stuck representing all the poor people who get screwed out of their plans, and having seen someone who worked for 20 years for the same employer receive a pension of $3,500 because it was integrated and because of the fractional rule, that is very discouraging for an individual, and we would like to ensure that there is adequate income for everyone, and that reflects the amount of years they worked and the commitment to the particular company.

We are concerned that with the cross-tested plans especially that only the highly-paid employees, the owner, will be protected and

receiving a pension benefit while the employer gets a tax credit for not providing anything to some of the other employees.

We are also very concerned about the age discrimination implications for age-weighted plans, and that is very hard to prove, to be honest.

Mr. LABEDZ. Mr. McCrery, if I may, just to add a little clarity to this issue from the point of view of large employers, the Treasury has stated that large-employer plans are often very broadly based and use cross testing appropriately, and they have stated publicly that they don't mean to go after large plans, yet the proposed legislation does, and included in our submission as appendix C is a recommendation from ERIC on how to refine the administration's proposal on cross testing.

Thank you.

Mr. McCRERY. Ms. Calimafde, you want the closing comment under the yellow light?

Ms. CALIMAFDE. That would be great. The kind of plan Ms. Gottlich is referring to has to be a defined-benefit plan. There is no such cutback in the world of defined-contribution plans, so I want you to know when you are talking about someone who worked for 20 years and walked away with $3,000, it can't be a top-heavy plan, because top-heavy plans require a certain minimum benefit every year.

Mr. PICKLE. Well, there seems to be some difference within the panel. I am glad for that. We have that same problem on the full committee.

Now, Mr. Labedz or Ms. Calimafde, I know that ERIC, your organization, has proposed that we would reduce the value of the PBGC guarantee by phasing it in over a period of 10 years, rather than the 5 years as it presently is under ERISA.

Now, the worker has no control over the funding of these plans. The worker has no access to the books or the facts and figures of a plan, and they are rather helpless about the benefits that they have been promised.

Why would Congress consider placing them, workers, at a greater risk by cutting back on the guarantee? Why would Congress do that?

Mr. LABEDZ. I think there are two important points here. First, our proposal is a balanced one and in certain other areas, especially as they relate to retirees and former participants, our funding proposal, and therefore our guarantee proposal, can be faster than current law. So there is a balanced approach there.

But second, what we are talking about and what we discussed this morning was exposure of the PBGC, and, although that is not the goal in this, there is a sense that one can solve this problem by having a commitment that parties enter into up front and knowingly. That is usually the case here because these benefits usually are collectively bargained, and thus we can extend a guarantee in a funding period at the same rate.

Mr. PICKLE. I could see why you would want to cut back on the funding or stretch it out for a longer period of time, but I don't know that you would be correct in letting the Congress make that decision when a worker can't do anything about it.

How would putting the workers at a greater risk of loss improve the defined-benefit pension plan system?

Mr. LABEDZ. Well, first the funding proposals as I say are often faster than current law, so we would be improving the funding status of plans.

Mr. PICKLE. The proposal speeds it up considerably.

Mr. LABEDZ. Yes, it does, as does the ERIC proposal.

Mr. PICKLE. If we speed it up faster, all these big companies that belong to your organization would be terribly hurt, wouldn't they, General Motors, Chrysler?

Mr. LABEDZ. We would have greater pension expense than I think a number of our companies could comfortably bear under the administration proposal, and so our proposal——

Mr. PICKLE. Are you saying that your companies—I am talking about the big five or six of them, they should be funding plans faster.

Mr. LABEDZ. We have committed to funding plans faster in our own proposal. We think we have a better way to do it than the administration bill.

Ours is a commitment that puts many millions of new dollars into pension trusts.

Mr. PICKLE. There are different ways to go about it, and I appreciate your testimony. Now, I noted some of you people had counsel to make testimony or referred to, and I know, ERIC, that you have Mrs. Gregory and Mr. Ugoretz out there.

I wonder if they want to make any statement at this point?

Mrs. GREGORY and Mr. UGORETZ. No.

Mr. PICKLE. That is good. That is good. We are glad to have you, and I thank all the panels for their testimony this afternoon.

Now the last panel will be Gregg Richter, chairman of the Pension Committee, representing the American Academy of Actuaries, then Stuart Opotowsky, vice president, Loews Corp., N.Y., and then Robert Spira, director of Government Relations, Multiemployer Pension Plan Solvency Coalition.

So if you people would take your positions at the table. Now, this panel, our first witness will be Gregg Richter, chairman, the Pension Committee, representing the American Academy of Actuaries, then followed by Stuart Opotowsky, I hope I am saying that right, representing the Loews Corp, and then the Multiemployer representative, Robert Spira.

First we will hear from Mr. Richter. Mr. Richter, and all your statements are going to be included in the record in its entirety. Mr. Richter.

STATEMENT OF GREGG RICHTER, CHAIRMAN, PENSION COMMITTEE, AMERICAN ACADEMY OF ACTUARIES; AND CONSULTANT, SEDGWICK NOBLE LOWNDES, CHICAGO, ILL.,

Mr. RICHTER. Thank you, Mr. Pickle. I appreciate the opportunity. I am Gregg Richter, an actuary here on behalf of the American Academy of Actuaries. With me is Lane West, who is a consulting actuary, also here on behalf of the American Academy of Actuaries. Both of us serve on the Pension Committee. American Academy of Actuaries is an umbrella organization that covers actuaries in all disciplines; actuaries that work in the insurance indus-

try, the health insurance industry, the pension industry. The Pension Committee deals specifically with those issues that impact pensions.

We commend the PBGC for promoting this legislation and also your own personal efforts, Mr. Pickle. We have been following that with interest over the years. We think on balance this is a positive proposal to strengthen the defined-benefit system and we encourage these efforts.

We have come here today with some suggestions we think could enhance the proposal. The first of those has to do with an issue that really is not addressed in this bill, yet has to do with what is called in the Tax Code Unanticipated Contingent Event Benefits. These are more commonly known as shutdown benefits.

Currently there is no provision in ERISA that requires employers to fund for these sorts of benefits. By way of explanation, a shutdown benefit refers to a benefit that is triggered only upon a company shutting down a division. It is usually in the form of enhanced early retirement benefits that will be paid to the workers affected by the plant shutdown.

Those type of benefits can easily double the value of the liabilities attributable to those particular workers, and as such, pose a great deal of risk to the Pension Benefit Guaranty Corp. Interestingly, it is really a small percentage of companies that offer these type of benefits, but the type of companies that offer these benefits tend to be large and cover substantial numbers of employees, therefore we are talking about substantial dollars of risk.

There is really no way an employer can adequately prefund these type of benefits. Most employers don't think that they are going to be shutting down plants and don't normally set aside money for that particular purpose.

The IRS regulations at this point in time would prohibit that funding anyway, so little or no prefunding of these benefits is done.

We currently have a premium structure in place for the Pension Benefit Guaranty Corporation, but that does not envision any sort of liability arising on account of these shutdown benefits. We support your principle of not wanting to reduce benefits for covered workers, but we think this system is out of balance. It is actuarially unsound and we would encourage some sort of remedy be put in place to cover these type of benefits, and we think that the most appropriate method would be some sort of an increased premium for those employers offering this type of benefit.

The second area I would like to talk about is plan amendments and the funding of plan amendments. We have heard some talk today about the deficit reduction contributions and how that would bring plans up to speed on benefits already promised in the past, benefits already in place under the plan.

But we have also heard some concern expressed here today about gaining proper accountability for employers putting new benefits in place. We have heard it suggested here that 30 years is probably too long a period to pay off liabilities for new benefits, and we tend to agree with that assessment. We would encourage consideration being given to a 10-year amortization on increased liabilities resulting as a result of plan amendments.

We think that would work well. The tax law currently allows an employer to take a deduction for a 10-year amortization. The tax law allows you to deduct the contribution for a 10-year amortization of those payments but doesn't require you to fund it that fast. We think that particular aspect ought to be changed.

Mr. PICKLE. Does that complete your statement, Mr. Richter?

Mr. RICHTER. I have got one additional point I would like to make. It has to do with the actuarial assumptions.

This particular bill, H.R. 3396, would require the use of a specific mortality table for the purpose of calculating the deficit reduction contribution and the amount of underfunding. We believe that it is inappropriate to specify a specific mortality table in the code and also the use of a specified interest rate for the purpose of developing the deficit reduction contribution. This would take the professional responsibility away from the actuaries and specifying it in the code.

We would like to see an approach developed where there could be more interaction with the government, with the Treasury, with the PBGC, with the Department of Labor and with the actuarial profession to develop appropriate standards, possibly a government office, an Office of the Actuary actually being established that would develop appropriate standards to make sure that these different liability measures are established and adhered to.

[The prepared statement follows:]

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
HEARING ON
H.R. 3396, RETIREMENT PROTECTION ACT OF 1993
THE ADMINISTRATION'S PROPOSAL TO
REFORM THE PENSION BENEFIT GUARANTY CORPORATION

TESTIMONY BY
GREGG RICHTER
ON BEHALF OF THE
PENSION COMMITTEE
AMERICAN ACADEMY OF ACTUARIES
APRIL 19, 1994

The American Academy of Actuaries is a national organization formed in 1965 to bring together into a single entity actuaries of all specialties within the United States. In addition to setting qualification standards and standards for actuarial practice, a major purpose of the Academy is to act as the public information voice of the profession. Academy committees regularly prepare testimony for Congress and state legislatures, provide information to legislative staff and policy makers, comment on proposed regulations, and work closely with state officials on issues related to insurance.

The Academy's 24-member Pension Committee consists of representatives from all areas of pension practice. The Committee includes actuaries who work with small as well as large plans, defined benefit plans and all types of defined contribution plans, union and nonunion plans, single-employer and multiemployer plans, and public as well as private plans. The Academy has over 11,000 members, all of whom are professional actuaries. The Pension Committee speaks on behalf of the 3,500 Academy members who are enrolled to practice under the Employee Retirement Income Security Act of 1974 (ERISA).

INTRODUCTION

The Academy's Pension Committee commends the Pension Benefit Guaranty Corporation (PBGC) for suggesting certain changes in the PBGC insurance program and in the minimum funding rules to strengthen the defined benefit pension insurance system and the pension plans which support it. One stated goal of the PBGC legislation is to improve the funded ratio (on a termination basis) for the fifty most underfunded plans from the current level of about 55 percent to a goal of 90 percent within 15 years.

This testimony provides additional suggestions to the PBGC proposal, as set forth in H.R. 3396, that will both enhance the proposal and make it a more balanced. Our comments include suggestions for:

- Strengthening funding requirements,
- Modifying funding requirements to smooth out volatility caused by actuarial gains and losses, and
- Improving the interaction between the actuarial profession and federal regulators.

UNANTICIPATED CONTINGENT EVENT BENEFITS

The concern with shutdown benefits is the unpredictability of these contingent benefits. Plan sponsors are not permitted to pre-fund unpredictable contingent benefits, and these benefits are not a factor in the determination of the annual PBGC premium.

The Pension Committee has debated the appropriate method for recognizing the liability for such benefits and has concluded that H.R. 3396 provides an excellent opportunity for Congress to put the insurance of plant shutdown benefits onto a sound basis.

Some pension plans contain benefits that commence only at plant shutdown, and under current law the PBGC is required to insure such benefits in an unusual and very unsound way -- with no advance funding and no PBGC premiums. The PBGC's substantial losses from shutdown benefits are absorbed by all insured defined benefit plans including those that contain no such benefits. The PBGC program is running a deficit, and losses on shutdown benefits consistently add to that deficit.

Current law does not permit employers to contribute for advance funding of shutdown benefits. Funding may not legally commence until after shutdown occurs and benefit payments begin. At that time it may be too late to fund these substantial liabilities because the employer is experiencing significant financial difficulties and the plan is terminating.

The tax code's reference to shutdown benefits as "unanticipated contingent event benefits," is correct. For any one plan, the actuary is not able to anticipate the chance that a plant shutdown will occur this year or the next year. For that reason, the Pension Committee does not recommended changing the rules on funding shutdown benefits, although, for the entire PBGC program, we are aware that some plant shutdowns are likely to occur this year and next year and the year after, triggering benefits for which PBGC premiums have never been paid. The Pension Committee does recommend, however, that all plans with shutdown benefits pay a somewhat higher premium every year, to cover the approximate cost of insuring unanticipated contingent event benefits.

At present, every plan that PBGC insures is paying for losses from plans with shutdown benefits. That is not only widely perceived as unfair, it is financially unsound. Moreover, a number of plans with shutdown benefits already have large unfunded liabilities. In these cases, the employer's bankruptcy will trigger substantial increases in the PBGC's losses.

Recommendations

Others have suggested that the PBGC stop insuring shutdown benefits. Instead, the Pension Committee suggests that the law be changed so that the PBGC begins to receive an appropriate premium for continuing to insure shutdown benefits. This is not a technically difficult change to implement.

Our recommendation is to include all potential shutdown benefits in the unfunded liability calculation that every plan uses to determine its variable-rate PBGC premiums. Thus, the PBGC will collect a premium that is based on the potential loss if shutdown benefits become payable. It would be acceptable to phase this change in over 5 years, or even to disregard shutdown benefits that increase liabilities by only a minimal amount such as 5 percent. We recognize that the PBGC premium rates have never been completely scientific, and the method may need to be adjusted as experience unfolds. For example, our proposal may understate the premium if plans with shutdown benefits also tend to have other unfunded benefits.

It is important to stop insuring shutdown benefits for free, and to start charging a premium that is based on potential PBGC losses on these benefits.

AMORTIZATION OF NEW LIABILITIES DUE TO PLAN AMENDMENTS

The Pension Committee agrees with the H.R. 3396 in that increases in collectively bargained benefits should be recognized immediately rather than over the life of the contract. The Pension Committee would do more, however.

Recommendations

The Pension Committee believes that conceptually, plan amendments resulting from collective bargaining should be amortized over the term of the collective bargaining

agreement. For other plan amendments, the current 30-year amortization is too long.

The Pension Committee suggests the minimum amortization period be set to 10 years for all amendments occurring one year or more after the effective date of the new law. Ten years is the fastest amendments can be amortized under current law. The proposal would balance the competing interest of plan security versus tax revenue loss.

Will this affect the level of benefits resulting from collective bargaining? It is the committee's sense that companies focus more on the cost under pension accounting rules (FAS87) than on the ERISA funding requirements. The Pension Committee, therefore, suggests that the level of benefits bargained would not be significantly affected by this change.

This recommendation improves the opportunity for the PBGC to reach its stated goal of at least 90 percent funding of all plans without increased pressure on the remaining defined benefit plan sponsors. This recommendation should also lead to more rational funding patterns as compared to those required under the current Deficit Reduction Contribution.

AMORTIZATION OF ACTUARIAL GAINS AND LOSSES

The Omnibus Budget Reconciliation Act of 1987 (OBRA 87) contained several provisions designed to strengthen funding of defined benefit plans. As the PBGC has pointed out, these changes have done little to strengthen the relative current liability funding ratios. Some, however, have adversely affected plan sponsors.

OBRA 87 changed the amortization of actuarial gains and losses from 15 years to five years. This change introduced unpredictable fluctuations in funding requirements which have been detrimental to the retention and formation of defined benefit plans and therefore indirectly hurt the PBGC insurance system.

Recommendations

We strongly recommend changing the actuarial gains and loss amortization period from 5 years to 10 years for minimum funding purposes.

This change should be revenue neutral. With the current requirement that assumptions be individually reasonable, a comparable number of actuarial gains and losses should occur and the total amortization in any year for all plans should be close to zero. This change will encourage defined benefit plans, will strengthen the PBGC insurance system and benefit American workers.

GUARANTEED BENEFITS

The Pension Committee supports the maintenance of the current level of guaranteed benefits and does not believe the solvency of the PBGC insurance system should be achieved by reducing insured benefits. However, the insurance system must employ the principles of insurance to protect itself and the plans which continue.

Recommendations

In conjunction with requiring the accelerated funding of benefit improvements over 10 years, the Pension Committee suggests the amount of the guaranteed benefit be based on the plan as it existed 3 years prior to any plan termination.

In conjunction with this change, the Pension Committee also suggests allowing each plan sponsor to base the variable premium calculation on the guaranteed benefit. This is particularly important for new plans which would have no guaranteed benefit for 3 years, and it may encourage new plan formation.

An alternative recommendation is a five year phase-in of benefit improvements as shown in the chart below.

Years	Old Rule	New Rule
0-1	0%	0%
1-2	20%	0%
2-3	40%	0%
3-4	60%	50%
4-5	80%	75%
5 or more	100%	100%

This suggested change may also encourage new plan formation.

ASSUMPTIONS FOR VARIABLE PREMIUM CALCULATION

The Pension Committee is concerned about the usurpment of professional actuarial responsibilities as the government continues to attempt to micro-manage the U.S. private pension system.

Recommendations — Mortality Table

As stated earlier, OBRA 87 requires pension actuaries to choose individually reasonable assumptions. This includes the mortality assumption. Actuaries use different mortality tables for different groups of participants. For example, persons in certain industries and occupations experience mortality rates that are higher than the average rates for other classes of employees. Disabled participants are another example of a group where a different table should be used. In addition, to base the calculation on an insurance reserve table can overstate the liability.

We, therefore, object to the imposition of a single mortality table as the basis for variable premium calculations. It is not reasonable to calculate the PBGC premium based on a table which may not be appropriate for a given plan. The table being used by the plan for the funding valuation should be sufficient for the premium calculation.

Recommendations — Interest Rate

An interest rate of 80 percent of the current 30-year Treasury note rate understates the rate used by insurers to price their annuities by 50 to 100 basis points or more. The Pension Committee thinks the rate should be increased to 100 percent of the 30-year Treasury rate. This is particularly important if the per capita cap on the variable premium is removed. In addition, the per capita cap should be removed only if the PBGC needs additional funding. The Pension Committee does not think the PBGC has provided sufficient evidence that this is true at present.

CURRENT LIABILITY INTEREST RATE

Under current law, the current liability is used to determine the Deficit Reduction Contribution. Actuaries should be allowed to make their own judgements regarding interest rate assumptions within the existing potential rate corridor.

The suggested corridor would result in an increase in the funding target that would require companies to fund towards an annuity cost target that overstates the value of accrued benefit obligations. This proxy for termination liability also overstates the comparable plan liability subject to SEC reporting requirements.

It should also be noted that there are now three interest rates required by the federal government for private pension plans: one for current liability calculation, one for variable premiums, and the SEC discount rate. It is difficult to justify this burden placed on plan sponsors.

Recommendations

The Pension Committee is concerned with the regulatory limitations placed on the actuary. While the Pension Committee agrees that regulatory guidance is needed, actuaries should be allowed, within reason, to use their judgement to assume the soundness of plan funding.

The Pension Committee strongly recommends that a specific mechanism, such as a restricted corridor, not be included in the Code. Rather, guidance for the actuary should be specified, such as allowing the current liability interest rates to reflect the current annuity rates.

IMPROVED RELATIONSHIP WITH THE ACTUARIAL PROFESSION

In reviewing H.R. 3396, the Academy thinks that communication between the profession and the involved federal agencies would improve the quality of future proposed legislation and final outcomes for the private retirement system. Both the federal government and the profession would benefit from a closer relationship.

A closer relationship would better serve the development of technical aspects in legislation, such as the Current Liability Interest Rate proposal in H.R. 3396. Increased interaction between the federal regulators and the actuarial profession would also encourage actuaries to make sound and proper assumptions while adhering to legislative and regulatory guidelines. Setting actuarial assumptions through legislation or such regulation as promulgation of a standard mortality table is unnecessary and in many cases is contrary to the best interests of plan participants.

This legislative proposal could take the opportunity to have the federal government and the actuarial profession work closer together by establishing an office of Government Actuary that would have the responsibility to work with the profession in establishing and monitoring standards of practice as they apply to ERISA plans. The Academy would work with Congress to establish the goals for the actuarial standards that the government actuary would implement a charter for the office.

CONCLUSION

Thank you for the opportunity to offer these comments and recommendations. The Pension Committee believes the recommendations included in this testimony are in the best interest of strengthening the PBGC and encouraging the growth of defined benefit plans.

The Pension Committee acknowledges that there are many challenges that face the PBGC, and we offer our support. Please contact the Academy if there are questions regarding our statement. The Pension Committee looks forward to continuing its relationship with the Ways and Means Committee and the PBGC as you move ahead on this important legislation.

Mr. PICKLE. Well, Mr. Richter, we—I don't want to hold up any of your other testimony, but we have many cases of evidence showing that many of the companies change their interest rates or choose a different mortality table, particularly in times when conditions are pretty tough, and they just do that to affect their pension plan. We know that. We have evidence of it.

Now, I don't know how we are going to stop it unless we take action to prohibit it. When we do that, we do run the risk of taking a table that doesn't fit every industry. But if you choose a table that has been recommended normally by the American insurance industry and they say that is the good balance, the so-called GAM 1983 table, we have to ask ourselves, is that fair or reasonable?

It may be a little bit unreasonable for some companies here and there, but it sure would put a stop to changing these rules at random at their own choice, and that is why the administration has put this change in there.

But we recognize that it is an arbitrary level and I don't know that that is always the best way to go about it. So some members are sincerely concerned about that part of it, and I think we have got to consider it, but at least it would do away with much of the abuse in the program, and that is what I think the administration is trying to do.

STATEMENT OF STUART OPOTOWSKY, VICE PRESIDENT-TAX, LOEWS CORP., NEW YORK, N.Y.

Mr. PICKLE. Now, the Chair will hear from Mr. Opotowsky.

Mr. OPOTOWSKY. I am vice president of tax of Loews Corp. Loews generally supports the efforts of your committee to further secure the private pension system and to strengthen the PBGC.

However, we strongly believe that Congress should enact legislation to enable companies such as Loews to more fully fund their underfunded pension plans by allowing for greater deductions and by eliminating the penalties on such funding.

H.R. 3396 is broad ranging, and I would like to focus just on three areas. First, the bill will, in some cases, require employers to make contributions to pension plans which would not be currently deductible. Second, the bill will, in some cases, require employers to make contributions to pension plans which would be subject to excise tax penalties, and third, the bill will in some cases, by phasing out the $53 per employee cap on variable rate PBGC premiums, increase premiums substantially in situations where employers were and are ready, willing and able to fully fund their plans had they not been inhibited from doing so by existing deductibility and excise tax limitations.

Loews is a substantial corporation with assets of over $45 billion and a net worth of over $6 billion. Yet, to our embarrassment, Loews appears each year on the PBGC list of the 50 corporations with the largest underfunding of pension plans, colloquially known as the "iffy fifty." Loews' appearance on this list is caused by the underfunding of a collectively bargained hourly pension plan of its subsidiary, Lorillard Tobacco Co.

Over the past few years, Lorillard has contributed the maximum amount it could to the Lorillard hourly pension plan on a deductible basis, not subject to excise tax penalties.

In addition, we initiated discussions with the PBGC and Congress as to ways in which Lorillard might contribute even more. The problem for Lorillard under the code as it now exists comes about because in addition to its collectively bargained hourly pension plan, Lorillard also has a collectively bargained hourly profit sharing plan.

Deductions for contributions to pension and profit sharing plans combined are limited under code section 404(a)(7) to 25 percent of the total aggregate compensation. Contributions in excess of the deductibility limits are also subject to a 10 percent excise tax penalty under code section 4972. Section 105 of the bill does offer some relief from excise tax penalties for 401(k) plans to a maximum of 6 percent compensation, but would not solve Loews' problem since the bill does not provide any relief where profit sharing plans are involved.

The bill's phase out of the cap of $53 per participant will result in an increase of more than $1 million a year in premiums for the Lorillard hourly pension plan. This is unreasonable and we believe it is manifestly unreasonable where the 25 percent of compensation limitation on deductions and excise tax penalties has prevented Lorillard from further funding its pension plan, where Lorillard has offered to contribute more and has petitioned PBGC and Congress to remove the limitations, where Lorillard's income has been well in excess of the underfunding each year for many years, and where the Loews' control group, which is statutorily liable under 4062 of ERISA for the underfunding has a net worth which is over 40 times the underfunding.

We have several proposed solutions to offer which are contained in our written statement, but we believe that the simplest solution is to create an exception to the 25 percent of compensation of deduction limit for collectively bargained plans.

In summary, Lorillard has been faced with the equivalent of a catch-22. If it adequately funds its pension plan, it is penalized in the form of nondeductibility and excise tax penalties. If it funds its pension plan just to the maximum extent it can while still avoiding those penalties, then it is penalized by excessive insurance premiums for the risk involved and by adverse publicity on the iffy fifty list.

I am confident that Congress will provide appropriate relief where equity clearly warrants it in situations such as ours. I thank you.

Mr. PICKLE. Thank you for your statement. We will take a look at your testimony. I think it is a matter of how much some of them will cost, but we will take a look at what you are recommending.

[The prepared statement follows:]

STATEMENT OF STUART OPOTOWSKY
VICE PRESIDENT-TAX OF LOEWS CORPORATION
BEFORE THE COMMITTEE ON WAYS AND MEANS

My name is Stuart Opotowsky. I am Vice President - Tax of Loews Corporation.

Loews generally supports the efforts of Congress to further secure the private pension system and to strengthen the PBGC. However, we strongly believe that Congress should enact legislation to enable companies such as Loews to reduce or eliminate their underfunded pensions on a more timely basis, by allowing for greater deductions and eliminating penalties.

The Retirement Protection Act of 1993 ("the Bill") is broadranging and I would like to focus my comments on three areas.

1. The Bill will, in some cases, require employers to make contributions to pension plans which would not be currently deductible.

2. The Bill will, in some cases, require employers to make contributions to pension plans which would be subject to excise tax penalties.

3. The Bill will, in some cases, by lifting the $53 per employee cap on variable rate PBGC premiums, increase premiums substantially in situations where employers were and are ready, willing and able to fully fund their plans had they not been inhibited from doing so by existing deductibility and excise tax limitations.

Loews is a substantial corporation with assets of over 45 billion dollars and a net worth of over 6 billion dollars. Yet, to our embarrassment, Loews appears each year on the PBGC list of the fifty corporations with the largest underfunding of pension plans, colloquially know as the "iffy fifty."

Loews appearance on this list is caused by the underfunding (approximately 140 million dollars using PBGC calculations) of a collectively bargained hourly pension plan of Lorillard. Over the past few years Lorillard has contributed the <u>maximum</u> amount it could to the Lorillard hourly pension plan on a deductible basis, not subject to excise tax penalties.

In addition, we initiated discussions with the PBGC and with Congress as to ways in which Lorillard might contribute even more. We were advised that even though extra contributions were desirable because they would strengthen the private pension system, Congress was not likely to permit deductions for such greater contributions since this would require a revenue raiser offset so as not to affect the deficit.

The problem for Loews under the Code as it now exists comes about because in addition to Lorillard's underfunded collectively bargained hourly pension plan, Lorillard also has a collectively bargained profit sharing plan. Deductions for combined contributions to pension and profit sharing plans are limited under Code Section 404(a)(7) to 25% of total aggregate compensation. The fact that contributions in excess of the 25% limitation may be carried forward for possible deduction in future years is not very helpful in a downsizing industry with a high proportion of retirees and older workers. This is especially true for an hourly pension plan where the benefit is based on a flat-rate formula of dollars per year of service, which under IRS rules creates additional past service liability each time a collectively bargained contract results in an increased pension benefit.

Contributions in excess of the deductible limits are also subject to a 10% excise tax penalty under Code Section 4972. Section 105 of the Bill does offer some relief from excise tax penalties for 401(k) plans to a maximum of 6% of compensation, but would not solve Loews problem since the Bill does not provide any relief where profit sharing plans are involved.

The Bill, while intended to increase minimum funding of substantially underfunded plans, will probably not affect the Lorillard contribution level. Our actuaries project that Lorillard's expected voluntary contribution level (up to the 25% limitation) will for the time being be higher than the increased minimum funding level proposed under the Bill.

The Bill also provides that for certain underfunded plans the PBGC variable insurance premium cap of $53 per participant will be phased out and the variable insurance underfunding formula of $9 per $1,000 will be applied without the cap. At first blush it seems reasonable to charge higher premiums to plans with the greatest underfunding on the assumption that this is where the greatest risk lies. But an increase in annual PBGC premiums for the Lorillard hourly pension plan of more than one million dollars is not reasonable -- and is manifestly unreasonable where:

1. the 25% of compensation limitation on deductions and excise tax penalties has prevented Lorillard from further funding the pension plan;

2. Lorillard has offered to contribute more and has petitioned the PBGC and Congress to remove the limitations;

3. Lorillard's income has been well in excess of the underfunding each year for many years; and

4. the Loews controlled group, which is statutorily liable under Section 4062 of ERISA for the underfunding, has a net worth which is over 40 times the underfunding.

The deductibility and excise tax problems exist under current law, but have not been cured and may have been exacerbated by the Bill. The PBGC premium has been raised by the Bill from a tolerable level to an unconscionable level. We have several proposed solutions to offer.

DEDUCTIBILITY LIMITATIONS

We would like to further fund the Lorillard hourly pension plan, if we were able to get statutory relief from the deductibility and penalty limitations. We would propose that the deduction limitations under the Code might be liberalized by restricting the 25% of compensation limitation to:

(i) plans which are not collectively bargained;

(ii) plans covering less than 100 employees;

(iii) plans with less than $50,000,000 of underfunding;

(iv) plans where the pension plan component is less than 25% underfunded; or

(v) any combination of the above.

In the alternative we would propose a one or two year window of relief from the 25% limitation.

EXCISE TAXES

If such relief provisions are enacted for deduction limitations, then relief will not be necessary for excise tax penalties. If such relief provisions are not enacted, then relief from excise tax penalties should be permitted by limiting the excise tax on nondeductible contributions to apply only when any one or more of the items enumerated above in roman numerals is present.

PBGC PREMIUMS

If relief is not granted from the existing deductibility and excise tax limitations, the proposed increase in PBGC premiums under the Bill should not be enacted. Companies should not be penalized now because Congress has limited their past and present contribution levels.

If relief from the deductibility and excise tax limitations is granted in the Bill, the proposed increase in premiums might nevertheless be amended to reflect real risk to the PBGC rather than an oversimplified numerical test. For example, a company or a controlled group with large income and large net worth which poses a de minimus risk to the PBGC should not be subject to the increased premiums.

In the alternative Congress might provide a mechanism for the employer to pledge Treasury Bills or other securities and to recalculate the variable rate premium of $9 per $1,000 of underfunding, based on the underfunding as reduced by the security.

SUMMARY

Lorillard has been faced with the equivalent of a "catch 22." If it adequately funds its pension plan it is penalized in the form of nondeductibility and excise tax penalties -- if it funds its pension plan to only the maximum extent it can while still avoiding these penalties, then it is penalized by excessive insurance premiums for the risk involved and by adverse publicity on the "iffy fifty" list.

Trying to strengthen the private retirement system without affecting the deficit is a quandary which should not be resolved by the expedient of requiring greater plan contributions (which are not currently deductible and which are subject to penalty excise taxes) and increasing PBGC premiums on plans whose underfunding has been mandated by the limitations of the Code. I am confident that Congress will provide appropriate relief where equity clearly warrants it, in situations such as ours.

STATEMENT OF ROBERT M. SPIRA, DIRECTOR OF GOVERNMENT RELATIONS AND SENIOR CORPORATE COUNSEL, LEASEWAY TRANSPORTATION CORP., BEACHWOOD, OHIO, ON BEHALF OF MULTIEMPLOYER PENSION PLAN SOLVENCY COALITION

Mr. PICKLE. Now I want to hear from Mr. Spira. We have a vote on, and we will not be able to come back because we have another Ways and Means Committee going on at the same time.

But Mr. Spira, I want you to proceed and make your statement as concise as you can, and I will try to respond to you.

Mr. SPIRA. Thank you, Mr. Chairman. My name is Robert Spira, director of government relations and senior corporate counsel, Leaseway Transportation Corp. I am pleased to appear before you this morning on behalf of the Multiemployer Pension Solvency Coalition. The coalition represents substantially all of the employers who contribute to multiemployer pension plans.

As you are aware, the Subcommittee on Oversight recommended that underfunded pension plans should not be able to promise additional unfunded benefits, the so-called cash or collateral rule. The coalition supports the cash or collateral rule as a necessary part of any pension reform.

As of 1992, there were 9 million employees covered under 2,000 multiemployer plans. Approximately 3 million of these employees are covered by plans that are currently underfunded. Many of these plans are funded at less than 90 percent. Many of these plans are underfunded by hundreds of millions of dollars.

We heard testimony from Secretary Reich this morning regarding the improvement in the multiemployer system. However, he is, I believe, looking at the wrong period of time because over the last several years, underfunding has increased in these plans. Since 1990 underfunding has more than doubled, from $5 billion to $11 billion.

While some of the increase can be attributed to declines in interest rates, some of it is also attributable to benefit increases voted by fund trustees. The recent increases in funding are even more significant when viewed in the context of the declines of the number of employees in these plans for whom contributions are made.

Deregulation in 1980 resulted in a dramatic realignment of the trucking industry. Nonunion segments have grown while traditional union carriers have languished. Employment levels in union trucking operations have declined by 40 percent since 1978.

These changes in the trucking industry have had a negative impact on the union-sponsored multiemployer plans. Many of the underfunded multiemployer plans have lost between 40 and 60 percent of their active employee participants since 1978. These declines are expected to continue.

The problems of employers that arise from multiemployer pension plan underfunding are real. My employer, Leaseway Transportation, is a trucking company with operations throughout the United States. Revenues for 1993 were approximately $630 million.

As a result of obligations under our union contracts, Leaseway contributes to more than 40 multiemployer plans. Leaseway's aggregate contingent withdrawal liabilities to these plans are estimated to exceed the company's $50 million net worth. Although

Leaseway does not desire to withdraw from the plans in which we participate, events outside the company's control, such as the cancellation of a major contract, could result in claims that exceed our ability to pay.

Other union trucking companies who are members of our coalition, particularly the smaller, family owned companies, are also threatened by their obligations to underfunded pension plans. These obligations make it difficult, if not impossible, for these individuals to reap the benefits of years of hard work and risk. Potential purchasers are not willing or able to assume contingent liabilities that far exceed the value of the business.

In addition, a company's financial results are affected because its pension fund obligations negatively impact credit ratings and interest rates. Employees who rely on severely underfunded multiemployer plans for their retirement benefits are also threatened by continued underfunding. If a plan becomes insolvent, PBGC guarantees a maximum of $487.50 a month for retirement benefits. This compares unfavorably to the $2,500 per month promised by some of the underfunded plans in the trucking industry.

PBGC and the administration have taken the position that the problem of underfunding in multiemployer plans is not so great that Congress needs to address it now. This position is unrealistic. PBGC has admitted that the insolvency of even one large multiemployer plan could threaten the small surplus in the multiemployer insurance fund.

Further, in September 1993 the General Accounting Office reported to Congress that the PBGC has not adequately assessed its liability for future assistance to financially troubled multiemployer plans. As we have demonstrated, there is a problem. The problem is getting worse and it will not go away by itself. The administration's efforts to deal with underfunding in single-employer defined-benefit plans, as reflected by H.R. 3396, will be incomplete unless they also deal with underfunding in multiemployer plans by including the cash or collateral rule. The attention now being given to single employer plan underfunding presents a perfect opportunity for Congress to correct the chronic underfunding in multiemployer plans as well.

Action should be taken now while the issue of pension funding is being considered by the Congress and before plan reorganizations and insolvencies occur. Employees are entitled to rely on the pension promises that are made to them.

Although potential restrictions that may arise from the cash or collateral rule might, at first glance, appear to be unfair, these restrictions are far less unfair to employees than a system that authorizes empty pension promises.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

STATEMENT OF ROBERT M. SPIRA, ESQ.
ON BEHALF OF
MULTIEMPLOYER PENSION PLAN SOLVENCY COALITION

Mr. Chairman and Members of the Committee:

My name is Robert M. Spira, I am Director of Government Relations and Senior Corporate Counsel for Leaseway Transportation Corp. I am pleased to submit this testimony on behalf of the Multiemployer Pension Plan Solvency Coalition ("Coalition"). The Coalition is composed of employers who contribute to multiemployer pension plans, and of industry trade associations that represent employers who contribute to multiemployer pension plans. These associations include the American Trucking Associations, Inc., the Associated General Contractors of America, the National Constructors Association, the National Association of Waterfront Employers and the Food Marketing Institute. The Coalition's principal goal is the passage of legislation that will address the serious problems caused by underfunding in multiemployer pension plans.

On June 4, 1993, the Subcommittee on Oversight issued a report to the Ways and Means Committee on the reform of the government's pension benefit guaranty program. One of the recommendations in the report is that underfunded pension plans should not be able to promise additional unfunded benefits -- the so-called "cash or collateral" rule. Our Coalition is in support of that recommendation. The cash or collateral rule is a necessary part of any pension reform. Other proposed solutions will not necessarily reduce pension plan underfunding, particularly in multiemployer plans, without a limitation on benefit increases.

Our position is supported by the following facts:

1. There are 9 million employees covered under 2,000 multiemployer plans as of 1992. Approximately 3 million of these employees are covered by plans that are currently underfunded. Many multiemployer plans are funded at less than 90%. <u>Underfunding in multiemployer plans increased from $5 billion in 1990 to $11 billion in 1992</u>. According to PBGC estimates, the rate of increase in underfunding in multiemployer plans between 1990 and 1992 may actually be greater than the rate of increase in underfunding in single-employer plans over the same period of time.

In 1990, PBGC reported that 89 percent of all multiemployer plans covering about 80 percent of all multiemployer plan participants were fully funded for vested benefits. By 1992, however, only 80 percent of all multiemployer plans (covering about 68 percent of all multiemployer plan participants) were fully funded for vested benefits. Therefore, the number of underfunded multiemployer plans is increasing. Exhibit A sets forth the levels of underfunding in certain multiemployer plans.

2. From 1980 until 1990 multiemployer plan underfunding decreased from a PBGC-alleged $33 billion to $5 billion. Since then <u>underfunding has more than doubled</u>. PBGC attributes this increase to the drop in interest rates and investment returns. However, a 1992 PBGC report states that both falling interest rates and <u>benefit increases</u> are the cause of this alarming rise in underfunding in these plans.

3. The recent increases in underfunding are even more significant when viewed in the context of the declines in the number of employees in these plans for whom contributions are made. Deregulation in 1980 resulted in a dramatic realignment of the trucking industry. Non-union segments have grown while traditional union carriers have languished. Employment levels in union trucking operations have decline by 40% since 1978.

These changes in the trucking industry have had a negative impact on union-sponsored multiemployer plans. Many of the underfunded multiemployer plans have lost between 40% and 60% of their active employee participants since 1978. These declines are expected to continue. Each decline in the contribution base of an underfunded multiemployer plan has the effect of increasing the exposures of the union employers who remain. Exhibit B illustrates the decline in the number of active employee participants in many of the most seriously underfunded plans.

4. In September, 1993, the General Accounting Office reported to Congress that the PBGC has not adequately assessed its liability for future financial assistance to financially-troubled multiemployer pension plans. As PBGC has admitted, if only one large multiemployer plan becomes insolvent, the surplus in the multiemployer insurance fund could be wiped out.

We have been informed by PBGC that it monitors the financial condition of its multiemployer program. PBGC's "watch list" of troubled plans will only be effective to the extent that a troubled plan experiences an orderly, visible and gradual decline in its financial condition. However, current economic and competitive conditions create a climate in some industries in which business failures could trigger uncollectible withdrawal liability claims at a pace far quicker than could be monitored effectively by the PBGC.

5. PBGC guarantees pension benefits well below the level retirees would expect to receive if they were to get all the benefits they were promised. The maximum PBGC guarantee is calculated at $16.25 times the employee's years of service. A pensioner with 30 years of service would be guaranteed to receive only $487.50 a month or $5,850 a year as compared with the $2,500 a month or $30,000 a year promised by some of the underfunded plans.

As we have demonstrated, multiemployer plan underfunding threatens the PBGC and the employees who are relying on plan benefits for their retirement income. However, the Committee should not lose sight of the impact of underfunding on the employers contributing to multiemployer plans. Under the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), employers are liable to the plan for their pro rata share of unfunded vested benefit liabilities ("withdrawal liability").

The problems of employers that arise from multiemployer pension plan underfunding are real. My employer, Leaseway Transportation Corp., is a trucking company with operations throughout the United States. Revenues for 1993 were approximately $630 million. As a result of obligations under our union contracts, Leaseway contributes to more than 40 multiemployer plans. Leaseway's aggregate contingent withdrawal liabilities to these plans are estimated to be in excess of the company's $50 million net worth. Although Leaseway does not desire to withdraw from any of the plans in which we participate, events outside of the company's control, such as the cancellation of a major contract, could result in claims that exceed our ability to pay.

Other union trucking companies who are members of our Coalition, particularly the smaller, family-owned companies, are also threatened by their obligations to underfunded pension plans. These obligations make it difficult, if not impossible, for these individuals to reap the benefits of years of hard work and risk. Potential purchasers are not willing or able to assume contingent liabilities that far exceed the value of the business. In addition, a company's financial results are affected because its pension fund obligations negatively impact credit ratings and interest rates.

Supporters for the present system have often claimed that multiemployer pension plan underfunding should be controlled through the collective bargaining process. This suggestion loses sight of what is and is not settled through collective bargaining. Wages and fringe benefit costs, including contributions to the pension fund, are negotiated through collective bargaining. Benefit levels are established by fund trustees.

The needed financial controls are not available to contributing employers through management of the funds. Although multiemployer funds have boards of trustees appointed in equal numbers by the unions and by management, once a trustee assumes the position as trustee, he or she has a duty of undivided loyalty to the beneficiaries of the plan's trust funds. Therefore, a trustee could not resist benefit improvements because of concern about the impact of those improvements on employers contributing to the fund.

Many solutions have been proposed to deal with the exposures to the PBGC's insurance fund. Across the board premium increases penalize fully funded plans by requiring them to incur additional expense as a result of the funding problems of other pension plans. Faster funding requirements, without a limitation on benefit increases, would not necessarily reduce pension plan underfunding.

We believe that strict adherence to two principles will resolve the problem. First, the focus should be on the underfunded plans. Second, the solution must ultimately encourage all pension plans to become fully funded. In addition to reducing the risk of claims against the PBGC's insurance program, full funding is the only way to assure that participating employees and retirees will receive the benefits they have been promised.

We recognize that managers of some multiemployer plans have expressed opposition to the cash or collateral rule because, in their opinion: (1) it is not necessary and (2) it is intended to undermine the multiemployer pension system. The trends in certain multiemployer plans which we described above -- increases in the level of underfunding, declines in the number of active employee participants, and increases in benefits -- demonstrate that changes are needed if underfunding is to be reduced.

The reductions in underfunding that should result from the legislation would not undermine the multiemployer pension system as some have feared. It is not the goal of the members of our Coalition to avoid withdrawal liability. Rather, it is our goal to eliminate such liability to the extent a fund is reasonably able to do so. A reduction in underfunding would not motivate contributing employers to withdraw from a multiemployer fund, but would eliminate one of the principle reasons why employers avoid commitments that require them to join a multiemployer fund. The legislation would result in a healthier pension system for employers and employees.

As we have demonstrated, there is a problem, the problem is getting worse and it will not go away by itself. The Administration's efforts to deal with underfunding in single-employer defined benefit plans, as reflected by H.R. 3396, will be incomplete unless they also deal with underfunding in multiemployer plans by including the cash or collateral rule. The attention now being given to single-employer plan underfunding presents a perfect opportunity for Congress to correct the chronic underfunding in multiemployer plans. Action should be taken now, while the issue of pension funding is being considered by the Congress and before plan reorganizations and insolvencies occur.

The solution proposed by the Subcommittee on Oversight and supported by our Coalition -- the cash or collateral rule -- is a simple one. The financial health of pension plans should be secured through limitations in unfunded benefit increases. The cash or collateral rule has also been endorsed by other pension experts as a necessary part of the solution of the larger underfunding problem that currently affects both single and multiemployer pension plans.

The cash or collateral rule is not a complete answer to the multiemployer pension plan problem. It will, however, help "stop the bleeding" by requiring a balance between a pension fund's financial standing and benefit increases.

Employees are entitled to rely on the pension promises that are made to them. Although potential restrictions that may arise from the cash or collateral rule might, at first glance, appear to be unfair, these restrictions are far less unfair to employees than a system that authorizes empty pension promises.

EXHIBIT A

Multiemployer Fund	Recent Plan Year/ Unfunded Vested Liability of the Plan[1]
Central States SE & SW Areas Pension Fund	1992/$1,414,416,000
NYSA-ILA Pension Trust Fund & Plan Board of Trustees	1991/$ 316,796,100
Teamsters Pension Trust of Philadelphia & Vicinity	1991/$ 228,828,938
Chicago Truck Drivers, Helpers & Warehouse Workers Union	1992/$ 86,458,300
Alaska Teamsters Employer Pension Trust	1991/$ 84,256,866
Western Pennsylvania Teamsters Pension Fund	1991/$ 70,323,139

[1] The Coalition has continued to research the funding status of multiemployer pension plans. In addition to the trends in the financial conditions of the funds, as described above, our study also demonstrated that certain trends which we described in our 1991 testimony to the Subcommittee on Oversight regarding the availability of information regarding multiemployer plans are continuing. Form 5500's are not available. When they are available, they are not complete or up to date. Thorough and comprehensive research is impossible. As indicated on Page 12 of The General Accounting Office's ("GAO") September 1993 Report to the Congress, the GAO has had similar problems finding information regarding the underfunded multiemployer plans.

EXHIBIT B[1]

Multiemployer Fund	Initial Plan Yr./No. Active Employee Participants	Most Recent Plan Yr./No. Active Employee Participants	Reduction During Period
Central States SE & SW Areas Pension Fund	1979/427,319	1992/226,818	47%
NYSA-ILA Pension Trust Fund & Plan Board of Trustees	1984/9,174[2]	1991/4,470	51%
Teamsters Pension Trust of Philadelphia & Vicinity	1979/31,196	1991/14,170	55%
Chicago Truck Drivers, Helpers & Warehouse Workers Union	1980/6,281	1992/2,137	66%
Alaska Teamsters Employer Pension Trust	1983/9,056	1991/3,679	59%
Western Pennsylvania Teamsters Pension Fund	1979/19,664	1991/9,861	50%

[1] Statistics have been updated to include the most recent information available as of April 1, 1994.

[2] Recognizing the problem, the contribution base unit measurement of this fund subsequently was changed from a man-hour basis to a tonnage basis.

Mr. PICKLE. If you will—I am trying to see how much time we have left on this vote. I am going to try to make this vote and I will come immediately back.

[Recess.]

Mr. PICKLE. I will ask the committee to come to order again.

Mr. Spira, I apologize for having left so abruptly, but we do have votes, and I just made it to the floor, but I came back simply to respond to you because you are entitled to the courtesy of an answer for some of the points you made.

There are some on the committee who feel very strongly that multiemployer plans should be made a part of this overall reform. We haven't done that for a number of years, and I think we should take another good look at it.

It is true that the trend may be improving. That is, the records, the statistics cited by the Secretary of Labor this morning show that the multiemployer plans have gone from some $30 billion down to $13 billion. And it is a declining trend and so that is encouraging, but there still is a possibility of considerable unfunded liability to PBGC, and I think that should be taken into consideration.

I have often wondered why we do not include multiemployer plans in with the single employer plans, at least at this day and time, and it is sort of an unanswerable question we pose from time to time.

I don't know what we will do, but I think we are approaching the time when we have got to take another good look at the multiemployer plans. I don't know what the approach or response may be.

Sometimes I wonder why PBGC doesn't take a more direct interest in it, and I guess partially the reason they don't, assuming they do not take a direct interest, is that they are not responsible for much of the benefits promised by multiemployer plans, and that would reduce your interest in a program if you aren't responsible for it basically.

I do think you have got a problem, especially in the area of some plans, companies who have joined a plan and for any number of reasons, wish to withdraw. Many of them can't afford to withdraw. The unfunded liabilities keep so high, the penalty liability for withdraw, if that is what we will term it, is so high that they are caught and they just can't afford to get out because they get ready to, they just raise the benefits or the indebtedness a little bit more, and that one company finds themselves obligated to pay more than they could really afford. That is not right. There is no equity to that.

If you wanted to get out, you might even be willing to pay a premium to do so. But when it costs you more than you could save if you got out, then that doesn't make sense to me.

But I do say that while we don't have the answers and while the administration is hesitant and did not recommend getting into the multiemployer area, I think there is some sentiment on the committee that we ought to take another good look at it, either now or some other point.

I just wanted you to know that we are not brushing it off because we consider it a serious problem. In the overall scope of things,

whether it is a defined-benefit, defined-contribution, or multiemployer, we ought to take another good look at it.

So I simply wanted you to know that as one member of the committee.

Mr. SPIRA. Thank you, Mr. Chairman. I want to clarify one point. Between 1980 and 1990, the underfunding decreased from the $30 billion range to the $5 billion range as Mr. Reich indicated. However, since 1990, it has gone from $5 billion to $11 billion.

So I think the relevant trend is not favorable, but unfavorable.

Mr. PICKLE. I didn't know that, but I can see why it might have gone back up. But it is a consideration we ought to view again. So I appreciate your mentioning that.

And, again, I want to say to all the participants, people who testified this morning, I thank you very much. This has been a long afternoon, but we still have votes on the floor and the Ways and Means Committee is meeting over on another matter now, so I am going to call this hearing to a close, and thank each of you for your testimony.

This has been an interesting and been a valuable, helpful series of panels. Thank you.

[Whereupon, at 2:53 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE

AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

FOR THE RECORD OF THE HEARING

OF THE COMMITTEE ON WAYS AND MEANS,

U.S. HOUSE OF REPRESENTATIVES

ON H.R. 3396

THE RETIREMENT PROTECTION ACT

APRIL 19, 1994

The Air Line Pilots Association, International ("ALPA") is the collective bargaining representative of 42,000 pilots who fly for 36 commercial airlines. ALPA appreciates this opportunity to submit comments to the House Ways and Means Committee on H.R. 3396, "The Retirement Protection Act," for the record of the hearing held April 19, 1994.

Pilots represented by ALPA participate in over a dozen collectively bargained single-employer defined benefit plans. (None of the plans is a multiemployer plan.) As a result, ALPA has had extensive experience with the issues addressed by H.R. 3396. For example:

- ALPA presently represents pilots in the termination of underfunded plans previously maintained by Eastern Air Lines and Pan American World Airways and now trusteed by the Pension Benefit Guaranty Corporation ("PBGC").

- Along with the PBGC and others, ALPA is a signatory to the January 1993 settlement of controlled group liability for the plans maintained on behalf of pilots and other employees of Trans World Airlines. Accomplishment of this settlement agreement avoided the termination of the TWA employees' defined benefit plans which had been threatened by the PBGC. Because a significant portion of pilots' benefits are not guaranteed by the PBGC, plan termination would have resulted in a loss of benefits to the pilots of approximately $300 million.

- ALPA represents the pilots' interests in connection with the PBGC's monitoring of the defined benefit plans maintained on behalf of pilots employed by Hawaiian Airlines and Northwest Airlines.

The comments which follow are based on ALPA's experience with these matters before the PBGC, accumulated over a period of more than ten years.

Strengthening the Funding Requirements. In general, ALPA supports the provisions of H.R. 3396 which strengthen the funding requirements applicable to underfunded plans, and which remove certain impediments to funding. ALPA supports certain provisions of the bill designed to strengthen the deficit reduction contribution ("DRC"), such as making the DRC a true minimum funding contribution, requiring use of an interest rate between 90% and 100% of the current liability interest rate, requiring use of a specified mortality table, presently the GAM 1983 mortality table, and restricting a plan sponsor's ability to change assumptions.

In addition, ALPA suggests a modification with respect to the required method for calculating a plan's "current liability." The DRC is imposed if a plan's assets are less than the plan's "current liability." The "current liability" is intended to operate as a measure of a plan's termination liability. As such, ALPA believes the "current liability" should be calculated using the same assumptions for interest and mortality as the PBGC uses in calculating the liabilities of a terminated plan. ALPA urges adoption of an amendment to the bill requiring the use of these assumptions.

However, ALPA opposes the bill's provision which extends the 30% DRC to plans with funding ratios between 35% and 60%. This requirement will operate as a disincentive to the establishment of defined benefit plans and will result in the lack of coverage of many employees under the defined benefit plan system.

<u>Funding Collectively Bargained Increases Effective in Future</u>. ALPA supports the bill's provision requiring employers to recognize immediately, for funding purposes, any benefit increases that have been negotiated pursuant to a collective bargaining agreement but which have not yet become effective.

<u>Strengthening PBGC Enforcement of ERISA</u>. ALPA also supports most -- but not all-- of the provisions designed to aid the PBGC in enforcing ERISA. For example, ALPA supports the bill's provisions which would require plan sponsors to provide PBGC with (a) advance notice of certain events which could threaten a plan's funding status, and (b) an annual notice of the controlled group's financial status. However, ALPA believes that the period of time within which the PBGC may bring an enforcement action for failure to comply with the advance notice requirement should be shortened from the maximum period of six years permitted by the bill.

<u>Improving Communications to Participants</u>. ALPA supports the bill's provisions requiring additional disclosure to plan participants regarding the funding status of the plan.

<u>Modifications to the Variable Rate Premium</u>. ALPA supports provisions in the bill designed to place the onus for payment of the variable rate premiums to the PBGC on those plans which pose the greatest risk to the PBGC. However, a plan poses no risk to the PBGC if it is fully funded for benefits guaranteed by the PBGC even though it is "underfunded" for all of its promised benefits. As an insurer, the PBGC should not be allowed to accept variable rate premiums from plans which pose no insurance risk to the PBGC.

Therefore, ALPA strongly urges the adoption of a provision which exempts from the variable rate premium requirement those plans which are fully funded for PBGC-guaranteed benefits (i.e., fully funded through Priority Category 4). In addition, for plans which are not fully funded for PBGC-guaranteed benefits, ALPA believes the level of underfunding for purposes of determining the applicable variable rate premium should be the level of underfunding for PBGC-guranteed benefits (i.e., through Priority Category 4), and not the level of underfunding for all vested benefits. Adoption of these two modifications will cause the bill to more closely meet the Committee's goals of placing the burden for the variable rate premium on plans which need coverage by the PBGC 's system of insurance.

<u>Modifications to Maximum Benefit Guaranteed by PBGC</u>. ALPA supports the provision in the bill which exempts certain disabled participants from the age reduction to the maximum amount of benefit guaranteed by the PBGC. The bill limits the exemption to individuals who meet the standards for Social Security benefits on account of total and permanent disability. ALPA urges the Committee also to exempt pilots who are disabled from flying, with respect to the benefits guaranteed under a defined benefit plan covering pilots. Like disability under the Social Security definition, disability to fly requires certification by an independent party. A physician qualified by the Federal Aviation Administration must determine whether a pilot meets or fails to meet the high physical standards set by the FAA. The determination must state whether the physician believes the condition is temporary or permanent. ALPA believes that only in cases where the

condition is determined to be permanent should the individual be exempted from the age reduction for PBGC-guaranteed benefits.

Furthermore, ALPA strongly urges an amendment to the bill which would provide that, with respect to pilots, the maximum guaranteed benefit applies at age 60, rather than age 65. Pilots are required *by law* to retire at age 60. Such a mandatory retirement age does not exist for other employees (with very limited exceptions). Rather, other employees have the right, *protected by law*, to continue working to any age.

Of course, the PBGC's maximum guaranteed benefit applies at age 65. PBGC requires a reduction to this maximum guaranteed benefit on account of commencement of benefits at ages younger than 65. A pilot retiring at his normal retirement age of 60 is forced to suffer a 35% reduction to the maximum guaranteed amount, reflecting a reduction of 7% for each year by which commencement precedes age 65. The reduction applies even though the pilot could not have continued working beyond age 60. ALPA strongly urges correction of this discriminatory provision. The bill should be amended to apply the full guaranteed benefit to pilots at age 60. Similarly, reductions for commencement of benefits earlier than age 60 should be made from age 60 and not age 65, with respect to pilots.

Correction of a similar problem was made under the Tax Reform Act of 1986. That problem involved application of the maximum dollar limit on benefits payable from a defined benefit plan under Section 415 of the Internal Revenue Code. For most employees, the maximum dollar limit applies at the employee's social security retirement age (age 65 through 67, depending on the employee's birth year), and reductions are required for commencement of benefits before the social security retirement age. In view of the pilots' mandatory retirement at age 60, however, a special rule was enacted applicable to commercial airline pilots. Now, under Section 415(b)(9), the maximum dollar limit is applicable to a commercial airline pilot at age 60, rather than at the pilot's social security retirement age.

<u>IRC Section 415 - Reduction for Commencement at Younger Ages</u>. Section 415 of the Internal Revenue Code sets forth rules to determine the maximum benefit payable under a defined benefit plan. Under present law, the maximum benefit payable at younger ages may be determined by applying an interest rate assumption of 5%, and no mortality assumption. Under the bill, the interest rate assumption must be the rate for 30-year treasury bills and the plan must use a specific mortality assumption (currently GAM 1983). Adoption of these provisions would result in lower amounts of pension being paid from defined benefit plans.

ALPA strongly opposes these modifications to Section 415. Over the years, ALPA has bargained early retirement benefits which in many cases come close to or exceed the limitations under Section 415. Where the qualified plan benefits exceed the limitations of 415, ALPA has attempted to bargain for replacement of the benefits under a nonqualified plan. Of course, nonqualified benefits are not subject to the anti-cutback rule, and are not funded; therefore, they are not secure. Reducing the maximum payable from a qualified plan forces more benefits to be placed at strong risk of being lost altogether. Although ALPA understands this to be a revenue measure, the "Retirement Protection Act" hardly seems like the appropriate vehicle to achieve this goal.

<u>Rounding Rules for Cost-of-Living Adjustments</u>. The bill would institute rounding rules applicable to annual cost-of-living adjustments made in Sections 415 and 402(g) of the Internal Revenue Code. Increases under Section 415 in the defined benefit dollar limit and the defined contribution dollar limit would not occur until accumulated cost-of-living adjustments have resulted in an increase of more than $5,000, and in such cases, the increases would be rounded down to the next lower multiple of $5,000. While ALPA agrees that rounding will reduce a minor administrative burden, we do not agree that $5,000 is the appropriate multiple. In the interest of protecting benefits in the form of qualified plans, ALPA urges the Committee to adopt a rule rounding the annual increase to the next lower multiple of $100.

Likewise, the bill would institute rounding in multiples of $500 for increases under Section 402(g) applicable to 401(k) plans. Of course, 401(k) plans represent the sole retirement benefit for many employees in the United States, including pilots. Therefore, ALPA urges the Committee to adopt a rule rounding the annual increase to the next lower multiple of $100.

Revise Rules on Full Funding Limitation, to Remove Negative Impact on PBGC. ALPA urges a re-examination and relaxation of the current full funding limitation rules. The present full funding limitations, imposed by the Omnibus Budget Reconciliation Act of 1987, prevent an employer from building up a proper level of reserves under a defined benefit plan to fund the plan's pension promises. The "full funding limitation" has resulted in a contribution holiday for many plan sponsors, leading potentially to additional unfunded PBGC termination liabilities.

ALPA understands that the "full funding limitation" was adopted to prevent the accumulation of assets in plans on behalf of owners and executives in small plans. It should have no application to large, collectively-bargained plans, which are not operated for the benefit of the sponsors' owners and executives.

Applicable law recognizes this principle in the case of the DRC requirements. Under present law, plans with less than 100 participants are exempt from the DRC requirements. This prevents a large accumulation of assets on behalf of owners under small plans. ALPA believes that a similar rule should apply in the case of the full funding limitation. Thus, ALPA urges an exemption from the full funding limitation requirements for plans which have 100 or more participants. The goal of Congress should be to facilitate, not to hinder, the funding of plans covering such a large number of employees.

Excise Tax on Asset Reversions Should Go to PBGC. ALPA believes that the PBGC, not the IRS, should be the recipient of any excise tax collected on asset reversions resulting from termination of some fully-funded defined benefit plans. As the healthier plans exit the PBGC insurance program, the PBGC's risk increases, creating the need for additional funding sources. Therefore, ALPA urges that the bill be amended to provide that the asset reversion excise tax be redirected to the PBGC.

Minimum Funding Waiver Reforms. ALPA urges that the bill be amended to provide that the PBGC, not the IRS, is empowered to grant or deny funding waivers. The IRS stands to lose nothing if it grants a funding waiver. The PBGC and the participants, however, stand to lose a lot if a funding waiver is granted. Therefore, the decision to grant or deny a funding waiver is more properly within the purview of the PBGC. In addition, the decision-maker should be required to consult with and involve plan participants and others who will be affected by the decision to grant or deny a waiver application, including the union in the case of a collectively bargained pension plan.

ALPA also urges adoption of an amendment requiring full disclosure of the financial information taken into consideration by the agency when considering an employer's request for a waiver of the minimum funding standard. Only through full disclosure of such information may plan participants and their representatives submit any meaningful comments to the agency.

Joint Trusteeship of Plans. ALPA urges adoption of a requirement that all pension plans have a joint board of trustees, consisting of equal numbers of participant and employer trustees. Joint boards of trustees for single employer plans would give employees input in decisions affecting employee assets, increase diversification of pension assets, and provide a much-needed system of checks and balances in the pension system.

Pension assets represent deferred wages of employees to which employees have a legal right. Employees give up a portion of current income to ensure future retirement security. Since pension assets represent employee money, employees should be able to participate in the management of those assets. Requiring employee representation on boards of trustees would foster broader views and broader participation in a decision-making process that directly impacts employees. Boards of trustees usually do not make

the day-to-day investment decisions, but do set investment strategy and select the investment managers who make the day-to-day investment decisions. Representation of both employee and employer interests in this decision-making process would result in investment decisions which are more thoroughly discussed and more tailored to participants' specific needs.

ALPA's favorable experience on several joint boards for defined *contribution* pension plans leads us to conclude that such a system would constitute an enhancement in the defined benefit plan arena as well.

Allow Non-Employer to Sponsor Plan. Regulations of the Internal Revenue Service provide that a "qualified plan" under Section 401(a) of the Internal Revenue Code must be a plan "of an employer." In other words, an *employer* must sponsor the plan. Under ERISA, however, an employee benefit plan (pension or welfare) may be maintained by an employer or an employee organization (union). It would be useful and appropriate to permit a qualified plan to be maintained by an employee organization under certain circumstances. When a company liquidates in bankruptcy and goes out of business, there is no longer an employer to sponsor the plans the company maintained. However, it may not be the best time for the plans to terminate. It may be of much greater benefit to the plan's participants (and also to the PBGC) if plan termination is deferred. If plan termination may be delayed until higher interest rates are available from insurance companies, more benefits may be purchased with the same dollars, leaving the PBGC with a lesser liability. Therefore, ALPA urges adoption of an amendment to the bill permitting an employee organization to sponsor a qualified plan.

PBGC-Trusteed Plans - Interface with Union. A collective bargaining representative should be given official status to consult with and to receive full disclosure from the PBGC on all matters under review by the PBGC concerning a defined benefit plan covering employees represented by the union. The collective bargaining representative should not be forced, as ALPA has been, to file a Freedom-of-Information-Act request to obtain information. ALPA urges the Committee to adopt a rule requiring the free flow of information from the PBGC to the union involved, thereby meeting one of the goals of the bill-- to provide greater information to participants regarding the funding status of the plan.

PBGC-Trusteed Plans - Claims Procedure. ALPA urges adoption of a rule requiring the PBGC to assume the employer's position under a trusteed plan's claims resolution procedures. The plan's claims resolution procedure should function as it would under an ongoing plan.

PBGC-Trusteed Plans - Issuance of "Initial Determination Letter". The PBGC is far too slow in issuing "initial determination letters" to participants in the plans it trustees. Only after an "initial determination letter" is issued may a participant file an appeal with the PBGC. ALPA's experience with the PBGC is that it takes many years after termination before this "initial" letter is issued. This means that a participant suffering an improperly reduced benefit must wait years for the correction to be made. Individuals represented by ALPA have actually received communications from the PBGC wherein the PBGC acknowledges that the individual's benefit was cut back too much, states that the cutback would be corrected in the future, at an uncertain time, and asserts that the individual will not be hurt because he will eventually receive back payments.

ALPA strongly urges the adoption of a maximum period of time within which the PBGC must issue "initial determination letters" to plan participants following trusteeship of the plan by the PBGC.

In conclusion, ALPA supports many provisions of H.R. 3396 but urges adoption of certain modifications to further safeguard pension benefits. ALPA welcomes the opportunity to discuss these comments further with members of the Committee or their designees. ALPA's contact for this purpose is Mr. David R. Vance, Director, Retirement and Insurance Department, who may be reached at (703) 689-4125.

AARP

April 19, 1994

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The American Association of Retired Persons commends you for holding hearings on H.R. 3396, the Retirement Protection Act of 1993, which addresses the financial soundness of the Pension Benefit Guaranty Corporation (PBGC). The Association believes that the financial integrity of the pension benefit guaranty program is an essential component of the retirement security framework. The PBGC must continue to be financially able to complete its mission to provide for the "timely and uninterrupted payment of pension benefits." Although the Retirement Protection Act fails to address the significant protection gap for annuitized benefits from PBGC covered plans, the bill is a significant first step towards addressing PBGC's projected long-term funding shortfall.

BACKGROUND

The PBGC was established under the Employee Retirement Income Security Act (ERISA) to guarantee some portion of benefits under employer-provided defined-benefit pension plans (currently up to $30,682 per year). This title of ERISA arose out of concern over the failure of individuals to get earned pension benefits in the event a plan terminated with insufficient assets to pay benefits. PBGC is designed to provide a federal pension safety net for federally regulated pension benefits that the plan is unable to pay.

PBGC is an independent wholly owned government corporation. In general, defined benefit plans, the only plans covered by PBGC, are required to be a part of the guarantee program. PBGC is intended to be a self-financing program, with revenue coming from employer-paid premiums (ranging from $19-$72 per participant), the assets of terminated plans and their sponsors, and investment income.

PBGC currently has a positive cash flow, which is expected to continue at least through the end of this century. PBGC's longer-term financial condition, however, has recently worsened. This is largely the result of the termination (and anticipated termination) of a small number of large underfunded plans concentrated in a few industries (steel, auto, airline and tire).

While pension underfunding is particularly concentrated in a small sector of the defined benefit plan universe, the system as a whole has generally seen improved funding since ERISA's enactment. Recent data indicates that about 75 percent of plans are fully funded (on a termination basis). PBGC's most recent estimates indicate that sytemwide, the funding status of single employer defined-benefit plans is 107 percent. Translated into dollar terms, PBGC estimates that the defined benefit pension system as a whole has over $100 billion more in assets than liabilities.

CURRENT ISSUES

Congress currently has the opportunity to make long-term deliberative changes in the system, without the threat of imminent crisis, that can ensure the long-term financial condition of the PBGC. The earlier corrective measures are made, the less drastic the measures that will be needed to ensure a proper course for the PBGC. Several problems must be addressed, and we again applaud you for bringing these issues to the forefront.

Minimum Funding

The minimum funding rules, which were recently improved in 1987 in the Pension Protection Act, once again need to be revisited. While the long-term impact of the 1987 changes, which significantly tightened funding rules, is not yet clear, additional changes may be necessary to better insure retirement benefit promises.

The Retirement Protection Act is a good first step towards strengthening funding in underfunded plans. The bill eliminates double counting of gains that currently weaken the funding rules, more narrowly specifies the assumptions that plans may use, and generally accelerates the time over which underfunded plans must be funded. The bill also removes certain tax disincentives that have worked to prevent some plan sponsors from contributing more than required under the minimum funding rules. In addition, the bill would phase out the current cap on the variable rate premium (based on a plan's funding status) paid by the employer, thus significantly increasing the premium for underfunded plans.

These and other changes should have as a goal the improvement of pension funding in the future, as well as the prevention of the deterioration of currently troubled plans. Recognizing that many companies currently in financial difficulty may also have a need for improved funding, it is important to strike the proper balance to ensure continued benefit security without undermining the plan itself.

This bill has rightly avoided the approach of tying future benefit guarantees to the funding status of the plan at the time the benefit was offered. AARP believes such an approach is fundamentally in conflict with PBGC's purpose of insuring retirement benefit security. Indeed, individuals with similar benefit expectations from two different companies, and even from the same company at different times, would find that the level of the federal guarantee is different. Such an approach would undermine PBGC's safety net role and would cause confusion and inconsistency among participants. AARP believes this bill correctly rejects this approach as inconsistent with the PBGC's mission and is unfair to participants.

Failure to Protect Annuitized Benefits

The Retirement Protection Act, while addressing a number of issues regarding PBGC's financial soundness, fails to address a gaping hole in PBGC's mission to protect defined benefit pension benefits.

The recent failure of several large insurance companies, particularly Executive Life Insurance Co. of California (ELIC), has underscored a giant omission in the federal framework protecting defined benefit pensions. Many defined benefit pension plans provide benefits in the form of insurance company annuities, both from ongoing plans and in plan terminations. While PBGC guarantees the benefit when it is provided directly by the pension plan, it is PBGC's most current position that it does not guarantee defined benefit pensions provided through an insurance company. This current position is, however, in direct conflict with the written position taken by PBGC in its 1981 regulation (46 Fed. Reg. 9532, at 9534) when it declared such annuities were covered by the PBGC guaranty. Indeed, the original guarantee, and the fact that annuitizing defined pension benefits was to be permitted, provided the basis upon which the regulation depended. The failure to protect such annuities undermines the entire federal pension safety net.

The current reversal of position by PBGC puts pension annuitants at risk that is not contemplated by ERISA. By no action of their own, pension annuitants effectively lose the federal protection that existed the moment they first became a part of the pension plan. In the absence of federal protection, annuitants must rely on the variations, gaps and unfunded nature of state insurance guaranty funds. The inadequacy of these state funds was amply demonstrated to Executive Life annuitants. When the state took over ELIC, annuitants saw their benefit levels reduced to seventy percent. Even in the event that such losses are fully made up, the fact remains that such protection will not occur in a timely manner. There are

an estimated 3-4 million persons receiving pension annuities. Retirees on fixed incomes cannot afford to wait years for state insurance funds to sort out who pays what to whom.

The problems faced by pension annuitants, particularly in the case of ELIC, are exacerbated by the fact that PBGC played a major role in their plight. The policy of pension terminations for reversions, which PBGC sanctioned in the early 1980's (along with the Department of Labor and the IRS), has negatively impacted PBGC in a variety of ways. First, PBGC's premium base was significantly diminished. Second, funding levels for those companies remaining in the system were reduced, putting PBGC at further risk. Lastly, PBGC required that annuities be purchased for pensioners in terminating plans, despite the fact that little, if any, oversight of the insurance carrier existed. The fact that reversions encouraged plans to choose the cheapest (in order to maximize reversions), not safest, annuity carrier led directly to the ELIC fiasco.

In order to close the annuity hole in the federal guaranty system which PBGC itself opened, PBGC must once again guarantee annuities. However, this does not mean that PBGC must open itself to a potentially large new liability. In order to minimize federal liabilities, a number of accompanying measures can also be adopted. Initially, standards should be put in place for the purchase of annuities, thus ensuring that only high-quality insurance carriers will be chosen. The Department of Labor has already put forth such a standard in numerous lawsuits it has filed on this issue. In addition, the state guarantee framework could be made to operate more efficiently and consistently with PBGC's mandate. For example, state guarantee funds could be made the first line of liability, with PBGC as an insurer of last resort. Alternatively, PBGC could be the initial payor but be able to recover funds from state guarantee funds on behalf of participants. In either case, participants should be able to receive timely and uninterrupted payment of benefits. Finally, if liability exposure is still deemed to exist, additional PBGC premiums (either one-time or ongoing) could be collected at the time of an annuity purchase.

Participant Disclosure

The bill properly would require underfunded plans to inform plan participants and beneficiaries about the underfunded status of the plan as well PBGC's guaranty limits, should the plan terminate while it is underfunded. Such notice is required to be written in a manner to be understood by the average plan participant. While the currently required Summary Annual Report (SAR) contains much information on the financial condition of the plan, it has been almost uniformly criticized as a document that is generally not readable and therefore of little use to the average plan participant. In addition, the SAR is not provided on a timely basis, and is not required to contain information about the extent of the PBGC guarantee.

Bankruptcy Changes

Currently, under ERISA, PBGC's claim against the plan sponsor of an underfunded terminated plan in bankruptcy situations is equal to the full amount of the unfunded benefit liabilities up to thirty percent of the sponsor's (and affiliates) net worth. However, recent bankruptcy court rulings have raised a number of issues as to PBGC's priority claims in bankruptcy. While ERISA gives PBGC some priority claims, such claims are not included in bankruptcy law. This lack of consistency has led to reduced recoveries for PBGC.

While not in this committee's jurisdiction, bankruptcy changes should be considered as part of any package to restore PBGC's financial integrity. Again, a balance must be struck between PBGC's interests and those of other creditors. In particular, retirees as a group often are the largest unsecured creditors due to the promise of retiree health benefits. Any changes to bankruptcy law must adequately reflect that changes to PBGC's recovery levels may directly and adversely impact retirees' claims for other benefits.

CONCLUSION

Continued pension plan underfunding places both the PBGC and the individuals that it guarantees at future risk of benefit loss. Changes now will improve PBGC's long term ability to pay benefits when necessary. However, pension annuities must also be made secure in order to ensure that defined benefit pensions, in whatever form, will be paid in a timely and uninterrupted manner.

The Association looks forward to working with the committee to ensure the long-term stability of PBGC, and thus the long-term security of the defined benefit pension promise. If you have further questions or issues you would like to discuss, please have your staff call David Certner of our Federal Affairs staff at (202) 434-3760.

Again, we commend you for raising the issues surrounding the financial status of the PBGC, and the recognition that it is an important component in the security provided by the federal pension benefit framework.

Sincerely,

Horace B. Deets

WRITTEN STATEMENT

of

AMERICAN COUNCIL ON EDUCATION

before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
Representative Dan Rostenkowski, Chairman

on

THE RETIREMENT PROTECTION ACT OF 1993 (H.R. 3396)

Submitted for the Record of Committee Hearing

on

Tuesday, April 19, 1994

on behalf of

American Association of State Colleges and Universities
College and University Personnel Association
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Independent Schools
Teachers Insurance and Annuity Association
and
College Retirement Equity Fund
The Variable Annuity Life Insurance Company

Written Stat‹ ment Submitted for

Ways and Means Committee Hearing Record
on
The Retirement Protection Act of 1993 (H.R. 3396)

April 19, 1994

The American Council on Education (ACE) and the other educational associations listed on the cover sheet recognize the important efforts of the Chairman and the Clinton Administration to strengthen the nation's pension system through "The Retirement Protection Act of 1993" (H.R. 3396). ACE and the other organizations that support this statement represent the majority of the nation's colleges, universities and independent schools. These educational employers have provided secure retirement income to their employees for decades. In fact in 1972, before he introduced the "Employment Retirement Income Security Act of 1974," (ERISA) Senator Jacob Javits cited our pension plans as role models:

> We need to learn something from the success of the college teachers' retirement system, TIAA-CREF, which would be a real model for private industry.[1]

Background

The vast majority of private and most public colleges and universities provide employees fully-funded, immediately-vested *defined contribution* retirement plans. The prevalent use of defined contribution plans, rather than defined benefit plans, as primary retirement plans for some or all of the employees of such institutions is longstanding, reflecting such considerations as portability and ease and cost of administration. Nonetheless, the principal purpose of these defined contribution plans is the same as that of defined benefit plans -- to provide retirement benefits.

America has a system of higher education that is highly regarded world-wide and that gives our country a strong competitive advantage. The nation-wide pool of highly trained and mobile educators is a key factor in creating and maintaining that quality. It is that mobility that allows the free interchange of ideas and people and enables American colleges to adapt to an ever-changing environment. And it is in no small part, the nation-wide system of fully-funded, immediately vested, and fully-portable defined contribution plans that has allowed this mobile work force to exist. The reality of colleges and universities competing for the best minds in America to join their faculties forces them to recruit on a national basis. At the same time, as significant employers in their communities, colleges must offer a salary and benefits that enables them to recruit support staff in the local work force.

While initially created to meet the needs of faculty at colleges and universities, many defined contribution retirement plans have expanded over the years to include support staff. Other institutions cover academic employees in defined contribution plans and cover non-academic employees in defined benefit retirement plans. This dual approach to retirement plan design is especially prevalent in the public sector, where state legislatures have enacted Optional Retirement Plans which are defined contribution

[1]U.S. Congress, House, Committee on Ways and Means, Tax Proposals Affecting Private Pension Plans: Hearings, 92nd Congress, 2nd sess., part 1 of 3, May 1972, 121.

plans to enable their state universities and colleges to recruit high caliber, nationally-known faculty members while states seek to maintain coverage under the public retirement plan for all other employees.

Coping with Nondiscrimination Rules

Most of these defined contribution retirement plans operate under Internal Revenue Code (IRC) Section 403(b). Since the nondiscrimination requirements were first imposed on 403(b) plans by the Tax Reform Act of 1986, the Internal Revenue Service (IRS) has delayed the effective date of the full nondiscrimination regulations on tax-exempt employers until January 1, 1996. This extended period has provided the opportunity for colleges and universities to fully analyze their plans and to adjust them, if needed, to comply with the nondiscrimination requirements. During the interim, colleges and universities have to demonstrate a good faith compliance with the general nondiscrimination regulation package under IRC Section 401(a)(4). They anticipate that these regulations offer a preview of the ultimate regulations the IRS will issue for plans that operate under Section 403(b).

For some colleges and universities which have historically offered age-graded or service-graded plans or provide retirement benefits to employees under a combination of defined benefit and defined contribution pensions, the ability to use cross-testing provides appropriate flexibility to satisfy the complex and mathematically exacting rules under IRC Section 401(a)(4). If the nondiscriminatory status of such plans hinged on the dispersion of allocation rates for each testing year, the results could be both unfair and misleading. A shift in participant demographics could find retirement plans falling into noncompliance and disrupting long-standing benefit promises.

The principle underlying benefits cross-testing is fundamentally sound. A contribution at a given rate for a 55-year old employee will provide a much lower retirement benefit than the same contribution made for a 30-year old employee, who has twenty-five additional years to accumulate with compound interest. In varying ways and with varying degrees of precision, many educational and charitable institutions have designed their retirement plans in a manner that compensates for that difference. These plans are not aggressive innovations designed to give maximum advantage to highly-compensated employees. In fact, many of the highly-compensated employees who today benefit from the higher allocation rates under age-graded or service-graded plans have worked for many years before qualifying for such allocations or reaching the income threshold that defines them as highly compensated. Such plans were often designed to recognize salary compression at the upper faculty ranks and help attract other faculty to institutions.

Our basic concern is not cross-testing itself, but the pitfalls of nondiscrimination rules as complex and mathematically exacting as those in the regulations under IRC Section 401(a)(4). Fully understanding the several hundred pages of nondiscrimination rules that the IRS will apply to exempt sector plans in 1996 presents a formidable compliance burden for business and benefits officers of educational and charitable employers. Under a totally new regime that involves triennial or even annual testing -- involving such nuances as rate groups, permissible measures of compensation, and benefits, rights and features -- plan provisions or plan combinations that are structurally fair and nondiscriminatory will inevitably pose compliance problems. In this context, cross-testing functions as a partial antidote to the risks of a mathematical system that does not look beyond the testing results for a single plan year.

Language of H.R. 3396 is Too Broadly V orded

The higher education community appreciates the concern of the Department of the Treasury about the potential for abuse of cross-testing in "new comparability plans" and age-weighted profit sharing plans that disproportionately concentrate retirement plan benefits in the accounts of a few highly-compensated employees. However, we believe that the broad language of H.R. 3396 covers all defined contribution plans, not just profit sharing plans, and will disrupt the pension plan configurations that have been common in the educational and charitable sector for many years without evidence of abuse.

The risk that high contribution rates will be effectively limited to highly-compensated employees is plainly greatest for plans that cover a relatively small number of employees, especially where the contribution rates are controlled by the older and most highly-compensated employees. Such plans are almost invariably top-heavy within the meaning of IRC Section 416(g). Congress in this section of the IRC has drawn a line between plans that operate for the primary benefit of the most highly-compensated employees and other plans. The purpose of the top-heavy section is similar to that of the proposed legislation -- to assure that lower-paid employees are not shortchanged by application of the normal nondiscrimination and minimum vesting requirements. Congress' conclusion that the Section 416 safeguards are not required for non-top-heavy plans seems an appropriate policy distinction for cross-testing, as well.

Allow Cross-Testing of Non-Top-Heavy Plans

Accordingly, we recommend that non-top-heavy plans be excepted from any cross-testing prohibition. The overwhelming majority of plans are predictably either top-heavy or non-top-heavy. Thus, a non-top-heavy exception would give many employers practical assurance that they could rely upon cross-testing principles on an ongoing basis. In turn, those employers would maintain stable contribution rates and preserve employee expectations. The possibility of abuse seems remote since nonhighly-compensated employees generally comprise a significant percentage of the participants in a non-top-heavy plan, and confining the high contribution rates to highly-compensated employees would be difficult.

In recommending a non-top-heavy exception, we recognize that Section 403(b) plans are not subject to the top-heavy rules. (The participants in a Section 403(b) plan never have an ownership interest in the employer and that the plan terms are typically controlled by independent boards.) However, the non-top-heavy exception could be limited to plans that are not top-heavy within the meaning of Section 416(g), without regard to whether Section 416 is directly applicable.

Other Appropriate Exceptions

We have addressed our concerns with this proposal in H.R. 3396 to the Department of the Treasury and proposed the non-top-heavy exception with three other recommended exceptions to the prohibition against cross-testing. Where any of those exceptions applied the risk of abuse would be minimal. The proposed exceptions are not conditioned on a minimum percentage of nonhighly-compensated employees qualifying for each rate of allocations each year. Any such test would be more difficult to apply and, in our view, too rigid. The three additional exceptions are:

1. Defined contribution plans combined with substantial defined benefit plans: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if it is combined with a defined benefit plan for any purpose under

Section 410(b) (including the average benefits test), and the defined benefit plan serves as the primary retirement plan for at least 30 percent of the employer's employees.

2. A maximum four to one ratio of allocation rates and all allocation rates available to a nondiscriminatory classification of employees: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if (i) the lowest allocation rate for any nonhighly-compensated employee was at least 25 percent of the highest allocation for any highly-compensated employee, and (ii) under the terms of the plan, each rate of allocations was currently and effectively available to a group of employees that constituted a nondiscriminatory classification within the meaning of Section 410(b)(2)(A)(i). For purposes of determining whether a rate of allocations was currently available to an employee, age and service conditions would be disregarded. For purposes of determining allocation rates, the plan's definition of compensation would be acceptable, and imputed disparity (as well as elective and matching contributions) would not be taken into account.

3. An average allocation rate for nonhighly-compensated employees equal to at least 40 percent of the highest allocation rate for any highly-compensated employee: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if the average allocation rate for nonhighly-compensated employees benefitting under the plan (and any other defined contribution plan with which it is combined for purposes of Section 410(b)) was at least 40 percent of the highest allocation rate for any highly-compensated employee benefitting under the plan (or plans). For purposes of determining allocation rates, the plan's definition of compensation would be accepted, and imputed disparity (as well as elective and matching contributions) would not be taken into account.

Rounding the Cost-of-Living

Additionally, Section 407 of H.R. 3396 raises some concerns for the sponsors of defined contribution plans. While rounding cost-of-living factors that applies to the \$90,000 defined benefit plan limit under Section 415(b)(1)(A) in increments of \$5,000 may be reasonable, applying that same \$5,000 increment to the \$30,000 Section 415(b)(1)(A) for defined contribution plans disturbs the four-to-one ratio established in the Tax Reform Act of 1986. Rounding the \$30,000 limit in \$1,000 increments would keep a closer balance while still reducing the administrative complexity. It would also avoid shifting to defined contribution plans an inequitable share of the burden for the tax revenue lost due to enhanced plan funding requirements for defined benefit retirement plans.

Conclusion

In conclusion, the legislative history of the Tax Reform Act of 1986 recognized the special circumstances of higher education. Congress' intent to allow 403(b) to be combined with 401(a) plans for coverage testing indicates a recognition that flexible aggregation is appropriate. With regard to rules on comparability of defined benefit and defined contribution pension plans, for example, the General Explanation of the Tax Reform Act of 1986 states, "Congress intended that the Secretary is to prescribe rules applicable to tax-sheltered annuities that reduce the administration burden of applying Revenue Ruling 81-102." In a similar vein, we urge Congress to maintain the availability of cross-testing for non-abusive plans of colleges, universities and independent schools.

Comments of The American Society of Pension Actuaries on

The Retirement Protection Act of 1993 H.R. 3396

The American Society of Pension Actuaries believes that the Retirement Protection Act of 1993, H.R. 3396, should not be enacted unless the ban in section 408 on cross-testing of defined contribution plans is deleted. If the ban on cross-testing is passed it would do substantial harm to the private retirement system.

The revision of the nondiscrimination regulations has been under Treasury Department consideration since the passage of the Tax Reform Act of 1986. Cross-testing was the primary focus of congressional intent when Congress instructed the secretary of the treasury in 1986 to rewrite the comparability rules. Cross-testing has been an essential element of the nondiscrimination regulations from the issuance of the first proposed regulations in 1989 through the issuance of the final regulations on September 3, 1993. Yet, on September 30, 1993, the Treasury Department proposed to include a ban on cross-testing of defined contribution plans in the PBGC bill.

For a younger worker, a contribution made to a cross-tested profit-sharing plan compounds for many years and translates into a benefit at retirement proportional to the benefit provided to the older worker at retirement.

Since 1982, continual change of the rules under which qualified retirement plans operate has been a major deterrent to employers adopting and maintaining these plans. As a consequence, the percentage of employees covered under qualified retirement plans has decreased during the last decade. The proposal to eliminate the cross-testing of profit-sharing plans comes after years of sanction of such cross-testing in proposed and final nondiscrimination regulations. The proposal would eliminate a plan design that has spurred growth in the adoption of retirement plans by small companies for the first time in many years, where coverage has traditionally been low.

We will submit more detailed comments on the funding and other provisions of the bill at a later date.

Statement Submitted for the Record

by

Terrell G. Womack, Vice President of Employee Benefits and Services

Champion International Corporation

Mr. Chairman and Members of the Committee, on behalf of Champion International Corporation and our 20,000 employees, I submit the following comments on H.R. 3396, The Retirement Protection Act of 1993. I am Terry Womack, Vice President of Employee Benefits and Services for Champion International Corporation.

Champion is a major producer of paper and wood products with facilities in 34 states. We are a strong and healthy company with total assets exceeding $9 billion and net worth exceeding $3 billion. To help ensure our long-term viability as an internationally competitive company, Champion has invested over $6 billion in capital improvements during the past nine years. These investments are already paying off in terms of increased productivity and improved environmental quality for the communities in which we operate. Our commitment to a sound, long-term future is also evidenced by aggressive reforestation efforts where some trees we plant today will not be harvested for another 50 years.

We are firmly committed to ensuring the welfare of our employees. This is evidenced by the generous level of benefits we provide, including defined benefit pensions, defined contribution plans with company matches to encourage savings, and health, disability, and life insurance coverages. Our commitment can be further evidenced by our history of retaining pension liabilities for divested locations in order to ensure the security of even former employees.

We currently have two, well funded defined benefit pension plans with assets that together total over $1 billion. The plans cover over 60,000 participants, of which 20,000 are already retired. On an IRS basis our plans are 125% and 115% funded, while on the PBGC's basis our plans are 97% and 93% funded. Champion is currently exempt from all PBGC variable premiums normally imposed on plan underfunding because we are fully funded by IRS standards. The IRS is also limiting our contributions since we are considered fully funded and have been for the past 4 out of 5 years. We are very confident that neither of these plans poses any risk to plan participants or to the PBGC in the foreseeable future. Champion hopes to continue using defined benefit pension plans to provide a significant portion of retirement benefits to our employees.

I. General Overview

The purpose of this hearing is to review the administration's proposal to reduce the risk to plan participants and to the PBGC from poorly funded pension plans. Champion fully supports this goal. However, we do not believe that H.R. 3396 will accomplish this objective in its current form. We believe the proposal is overly broad and places unreasonable burdens on sponsors of responsibly funded plans. It unnecessarily adds further complexity to the rules and makes it more difficult for all plan sponsors (both fully funded and underfunded) to predict future funding requirements. We believe the objectives of the PBGC and the Congress can be better met by making only those changes to the current rules that narrowly focus on problem companies and the specific risks they pose as plan sponsors.

Over the years, privately sponsored, defined benefit pension plans have relieved the Federal Government of significant burden. We believe that defined benefit pensions still provide the best retirement protection available to employees. However, as more legislation is imposed, the responsibility of funding and administering these plans is becoming overly burdensome for corporate plan sponsors. We believe that any changes should be carefully designed to avoid pushing responsible employers further away from defined benefit arrangements.

From our vantage point, one real problem is the dichotomy of perspectives between business planning, the IRS, and the PBGC. Most businesses fund pension plans like other investments—on a long-term rather than a short-term basis. The IRS evaluates pension plans on a long-term, ongoing basis while the PBGC continues to focus on a short-term, terminating plan basis. Ironically, the struggle between the IRS and the PBGC perspectives can sometimes result in responsibly funded plans sponsored by healthy companies being named to the PBGC's annual list of the worst funded plans in the country! At the same time, many poorly funded plans are not listed even though they pose a much higher risk of default.

The appropriate perspective for each plan should be based on its level of underfunding and on the economic health of the company and its outlook for future prosperity. Otherwise, companies like Champion will continue to be caught in the struggle between long-term measures used by the IRS and short-term measures used by the PBGC. The only provision that currently bridges this gap in perspectives is the exemption from variable PBGC premiums for those plans considered fully funded by the IRS. Any final legislation must preserve this exemption, as does H.R. 3396, in order to encourage responsible funding policies of plan sponsors.

Since the focus of any successful corporation needs to be on long-term prosperity, any short-term measures used by the PBGC should be adjusted for that specific use. For example, short-term measures are necessary in plan terminations. In trying to predict the potential exposure that any plan poses to the PBGC, these measures should be tempered with the probability of plan sponsor default. Short-term measures have no real meaning without dual consideration of the economic health of the sponsor. Therefore, the PBGC needs to develop solvency factors that consider both plan and plan sponsor health and then incorporate these factors in its short-term measurements.

Both the Top 50 list and any further PBGC legislation should sharpen the focus on truly problem plans and more accurately reflect the relative risk posed to the PBGC and plan participants by the particular company. More complicated and more stringent funding requirements for *all* plans or increased premiums, which are excessive relative to the risk posed by the particular company, are not warranted and should be avoided.

We are concerned about a number of items in the proposal as it stands. We believe the following provisions are insufficiently targeted in that they will not only impact poorly funded plans but will also hurt sponsors of responsibly funded plans. In the interest of focusing on the real problem at hand, we believe that adjustments should be made to the following provisions of H.R. 3396:

- the restriction on actuarial assumptions used for current liability,
- the proposed treatment of negotiated benefit increases, and
- the planned increases in PBGC premiums.

Each of these provisions is addressed separately below in terms of our concerns and some suggested changes which would help focus the provisions on poorly funded plans.

II. Actuarial Assumptions for Current Liability

The measure of current liability was first introduced as part of the Additional Deficit Reduction Contribution rules. These rules require that additional contributions be made to poorly funded plans. As it stands, current liability must be calculated with an interest rate that is within a corridor defined by the IRS. As market interest rates drop, so do the rates in the corridor for current liability. Therefore, more and more plans are being subjected to these additional contributions. H.R. 3396 proposes to further restrict the assumptions available for this calculation by both narrowing the range of allowable interest rates to a lower level and mandating the use of a single mortality table.

Our Concerns

We disagree with both the narrowing of the corridor for allowable interest rates and the mandated mortality assumption in H.R. 3396. It is unreasonable to judge the liability of all plans on such a narrowly defined set of assumptions. Plans vary in many ways, and these variations need to be considered in determining appropriate assumptions. Some facts that must be considered include the demographics of the plan population, the size of the investment pool, the chosen investment policy, the past experience of the plan, and the health of the plan sponsor. Under current law the PBGC has a claim against the net worth of a company, which in Champion's case is more than $3 billion. Even on the PBGC's short-term basis, our plans are only $64 million underfunded and could easily be supported by our net worth.

Is it appropriate to value a short-term liability with the same interest rate as a long-term liability? We think not. Wide variations exist in the make-up of plan liabilities and the health of plan sponsors that would result in variations in suitable interest rates. H.R. 3396 puts even more emphasis on volatile, short-term interest rates. Plan sponsors that pose no real risk of termination in the near future should not be burdened with the unpredictability of short-term interest rates. We need to run our company based on a sound, long-term business plan, which in turn requires that both our labor and production expenses be predictable to every extent possible.

On a long-term basis, Champion's pension plans are 120% funded in total. On a short-term PBGC basis, this translates to 95%. Given the volatility in short-term interest rates, our funded ratio on the PBGC's basis can fluctuate significantly. For example, the change in interest rates alone from 1992 to 1994 increased our liabilities by over 20% or $200 million. Funding that increase in liabilities over a short period would prove to be a significant and unnecessary burden to Champion. If interest rates later increased again, we would be considered overfunded and our contributions would be restricted. Why should we be subjected to volatile contribution requirements when these short-term measures have no real bearing on the long-term viability of the plan? In the meantime, these unnecessary contributions based on short-term interest rates would have deprived our business of capital normally available for reinvestment toward company growth, increased wages, or increased return to shareholders. One goal in designing funding rules should be to make the contribution requirements predictable, instead of having them fluctuate erratically with temporary changes in interest rates. The only way to accomplish this is to focus on long-term expectations.

In addition to variations in interest rates, appropriate variations also exist for mortality assumptions. There are real differences in mortality rates among different classifications which are evidenced by insurance company experience. A valuation is intended to provide the best estimate of the cost of future benefits for the specific population of plan participants. Clearly then, the same mortality table and interest rate cannot be appropriate for every plan. It would be a grave public policy mistake if all valuations were required to be performed with the same set of assumptions.

Suggested Changes

As mentioned earlier, it is essential in our opinion that the PBGC short-term, plan-termination type measures be adjusted for the funded status of the plan and the probability of actual plan sponsor default. The PBGC should recognize that $1 million in underfunding for a plan that is 99% funded does not carry the same threat as $1 million in underfunding for a plan that is 50% funded. Also, the economic health of the company should be considered through solvency factors. For simplicity and reasonability, we suggest these factors be based on rating criteria that already exist, like the Dunn and Bradstreet or Moody's financial ratings. The PBGC would then need to incorporate these factors into its short-term measurements.

There are a number of adjustments that should be made to recognize the health of the plan and plan sponsor:

- Alternatively, the current corridor for interest rates could be maintained so that some discretion could be applied with regard to individual situations.

- For the PBGC Top-50 list, companies are currently chosen based solely on the dollar amount of underfunding on a PBGC short-term basis. Even if interest rate reductions have a similar percentage impact on two plans, the dollar increase in underfunding will be greater for the larger plan. For example, a 1% decrease in funded status for Champion translates to over $10 million in additional liabilities. This can result in even well funded plans being included on the list due to their size and the leveraging that takes place in a low interest rate environment. This list should be more clearly focused on problem plans by incorporating the plan funded ratios in the criteria for choosing the 50 companies.

III. Negotiated Benefit Increases

H.R. 3396 requires that liabilities for funding include all negotiated future benefit increases. Under current law only those benefit provisions that are currently in place need be considered.

Our Concerns

We believe it would be inappropriate to require that all negotiated benefit increases be reflected in the liabilities for immediate funding when they are not currently effective. Why? Because these benefits have not yet been earned and are not yet available to new retirees. If a sponsor were forced to terminate a plan before the effective date of a negotiated benefit structure, these benefits would not necessarily be fully protected under ERISA or guaranteed by the PBGC.

Since we do not foresee any plan terminations in Champion's future, we are mainly concerned with appropriately matching expense against income. Currently we pay for the cost of negotiated benefit increases over time with corresponding price and productivity increases on our paper products. It would be unfair and harmful to our business to charge Champion for the benefit increases before we can offset them with price and productivity increases. Any premature reflection of expense in our product prices would jeopardize our competitive standing internationally.

We have a similar problem with any requirement to collateralize negotiated benefit improvements, other than for very poorly funded plans. Any requirement mandating early recognition of future increases could force us into shorter labor contracts. Shorter contracts would clearly diminish the continuity necessary to foster our team environment, which we believe is necessary to maintain a highly competitive market position. This effect on a widespread basis would be detrimental to the overall stability of our economy.

Suggested Changes

A much more direct and logical way to promote faster funding of negotiated benefit increases would be to require that the associated increases in liability be amortized over the average remaining service of the affected employees (generally 12-18 years), instead of the 30 years currently allowed for all plan amendments. This would avoid recognition of future benefits that are not yet available but would still hasten the funding of these newly created liabilities for past service. It would also help us maintain a reasonable connection between the expense of doing business and the income flow associated with that business.

IV. PBGC Premiums

Currently PBGC premiums consist of a $19 per person charge plus an additional $9 charge per $1,000 in underfunding per participant. The total annual charge is capped at $72 per person. H.R. 3396 would continue this structure, but remove the $72 cap.

Our Concerns

We fear that the PBGC premiums for well funded plans may become excessive if the current $72 cap is removed from the variable rate portion. The intention of removing the cap is to fully recognize in the premiums the underfunding in poorly funded plans: removing the cap could provide further incentive for sponsors of these plans to strengthen their funding policy. These are admirable purposes, but they need to be accomplished more deliberately so that sponsors of responsibly funded plans are not also penalized.

Removing the cap leaves even well funded plans with unpredictable exposure. If interest rates drop drastically, most plan sponsors will be subject to large increases in variable premiums, due solely to temporary market conditions; and there is no direct benefit derived for the plan or plan participants from these unnecessary premiums. Currently that exposure is capped at $72 per person which gives employers at least some certainty. Removing the cap without somehow factoring in the viability of the plan sponsor would again be penalizing all plan

sponsors for the unpredictability of short-term interest rates, even where they have no *real* application.

Suggested Changes

We believe the premium cap should not be removed for well funded plans. If, however, Congress accepts the general direction of the PBGC's recommendation, we would strongly urge Congress not accept the method in which PBGC has proposed to increase premiums. Any premium increase structure should not penalize responsibly funded plans that are caught by temporary fluctuations in interest rates.

One option would be to allow well funded plans to pay any premium amount in excess of the $72 level to their plans instead of to the PBGC. At least this way plan participants would derive some benefit from the use of short-term measurements by the PBGC.

In Summary

Champion supports the general goals of H.R. 3396. We believe that responsibly funded, defined benefit pension plans provide important security to employees. We believe the majority of plan sponsors are taking this responsibility to heart and are acting in the best interest of their employees.

To preserve the security of our employees, we must also concentrate on our viability as an employer. In order to do this we need to make significant investments in both the manufacturing assets of the corporation and the training and development of our employees. To do that efficiently we need our expenses to be as predictable as possible so that they appropriately match our income. We ask for your help in providing some certainty to our pension contributions and premiums by using long-term assumptions for generally healthy companies and plans.

In some cases, plan sponsors have taken their commitment too lightly by allowing their plans to become severely underfunded. However, the burden for these companies should not be shifted to responsible companies or to the government. Instead, we need a fair way to identify these companies and force them into further funding to improve plan security. The best way to accomplish this is through incorporation of solvency measures both for pension plans and their sponsors in all short-term measures.

Statement of
Francis X. McArdle
Managing Director, General
Contractors Association of New York, Inc.

The General Contractors Association of New York (Association) is a trade association of one hundred and twenty members active in the heavy construction industry in New York City. The Association undertakes to negotiate fourteen different labor agreements for our members with the local unions involved in the construction trades. Through these collective bargaining agreements our members participate in ten separate multi-employer pension fund trusts; the Association appoints management trustees to nine of them. Thus, the Association has a direct and vital interest in pension legislation adopted at the federal level and any reforms proposed to that legislation.

The legislation proposed by the Administration, which is before the Committee at this time, does not propose any changes that would affect multi-employer plans. The Association is concerned that an opportunity is being lost to examine the state of multi-employer plans and to consider appropriate reforms based on that examination. The concern of the Association arises from the growing gap between the value of credits being provided to retirees by plans and the amount of that credit that is covered by PBGC guarantees. Currently, PBGC protects less than $20 for each year of credit service, while some of the Association's plans provide credits worth in excess of $50 per credit.

The gap is of no consequence when plans are fully funded. But currently there is no federal prohibition against the widening of that gap by plans that are not fully funded. Legislation introduced by Representative Pickle last year, H.R. 298, would have required underfunded plans, whether multi-employer or single-employer, to forgo increases in pension fund benefits unless the plan was ninety percent funded. This seemed an appropriate threshold to the Executive Committee of the Association. The adoption of this approach would work to assure that there is no greater exposure created for the covered employees, for the employers, or for the Pension Benefit Guarantee Corporation. Such legislation would provide a clear mandate to the trustees, both management and labor, of the multi-employer funds.

It may be that there are few, if any, multi-employer plans that would fail the ninety percent threshold test. The Association is unaware of any annual reports from the United States Department of Labor that characterize the funding level of multi-employer plans. Such information would be useful to assess the impact of H.R. 298 or any bill affecting the Pension Benefit Guaranty Corporation approved by the Committee. The Association urges the Committee to act to obtain that information and to consider carefully the approach that has been suggested by Mr. Pickle.

STATEMENT OF DONALD S. GRUBBS, JR.
FOR THE RECORD OF THE HEARING ON APRIL 19, 1994
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Introduction

My name is Donald S. Grubbs, Jr. I am President of Grubbs and Company, Inc., a consulting actuarial firm located in Silver Spring, Maryland. I am a Fellow of the Society of Actuaries and am admitted to the District of Columbia Bar. I was formerly Director of the Actuarial Division of the Internal Revenue Service.

My comments are solely my own and do not represent any client or any of the organizations with which I am affiliated. They are presented in an effort to help bring an adequate retirement income to more American workers.

The plan termination insurance program, which is designed to protect pension benefits, faces some long-term problems. Both the Congress and the Administration are to be commended for recognizing these problems and exploring possible solutions. H.R. 3396 addresses these problems with proposals to strengthen plan funding and other steps intended to bolster the plan termination insurance program.

Although well intentioned, many provisions of this bill would add complexity and regulatory burdens that would discourage defined benefit pension plans, and thus would actually be harmful to plan participants. My comments address the problems and suggest alternative ways to accomplish the objectives of the bill in a way that will bring more retirement income security to more employees. Except as indicated, my comments do not address multiemployer plans. I am separately providing the Committee an Appendix to these comments, which presents section-by-section comments on some of the details of the bill.

The Big Problem

Approximately 100 million Americans now work in nongovernmental employment. Most of these will receive no pension at all as the result of their current employment, simply because they are not participants in any employer-provided pension plan. Lack of coverage is the primary reason that many Americans will not receive an adequate retirement income. In recent years the problem has been getting worse, with the percentage of employees who are covered under a plan of their current employer gradually declining. One of the major causes of this problem is the growing complexity and administrative burden of regulatory requirements that govern pension plans. The complexity of the minimum funding requirements is part of this problem. Large and sporadic increases in the PBGC premium rate, from $1 per participant in 1974 to as much as $72 today, have also discouraged coverage. These burdens, and the constant change in the rules that leave employers in a state of confusion, have discouraged employers - particularly small employers - from establishing and maintaining plans.

The other problems facing pension plans, although significant, are very minor compared to the big problem of lack of coverage. The number of employees covered under pension plans that terminate with unfunded guaranteed benefits is very small in comparison to the millions that are not even covered under a plan. When it enacted ERISA, Congress recognized the importance of coverage and stated that the first purpose of PBGC was "to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants."

We need to address all of the problems of the pension system, but in doing so we must try to make the coverage problem better, not worse. H.R. 3396 is a responsible effort to solve problems facing the pension insurance system and it has many good features. Unfortunately parts of the bill would add more complexity and regulatory burdens, and the overall effect would be to discourage employers from establishing and maintaining defined benefit pension plans.

The Problem of the Pension Insurance System

To protect participants from losing unfunded benefits through termination of pension plans, ERISA has a three-part program:

1. Minimum funding requirements were established to require employers to soundly fund their plans. Each year employers must contribute the plan's current cost and make an additional payment to amortize any unfunded liability over a period of years.

2. Employers are prohibited from terminating a pension plan while the plan has any unfunded benefits unless the employer is in a "distress" such as a bankruptcy proceeding.

3. Under the plan termination insurance program PBGC guarantees most vested benefits under plans that terminate in distress terminations. The program has two parts, one for multiemployer plans and one for single employer plans. The costs of this program are met by three sources of income:

   - premiums paid by all employers that maintain defined benefit plans covered under the program,

   - payments from employers that terminate their plans, and

   - investment income earned by PBGC's funds.

To date PBGC has met all of its obligations, and is expected to be able to do so for many years in the future, even if no change is made in the program. However, PBGC has some long-range problems. Projections indicate that the various sources of income will not be sufficient to pay the costs of the program in the long run unless changes are made to either increase the program's income or decrease its expenditures. While there is no immediate crisis, taking corrective measures sooner rather than later will reduce the cost of solving the problems in the long run. However, it is far more important to develop good solutions than to rush into solutions that may actually harm the private pension system.

Unfunded Accrued Benefits - a Normal Phase of Pension Plans

Almost every pension plan in America began with unfunded benefits credited for past service years before the plan was established. Without crediting benefits for past service, older workers could not receive adequate pensions. Crediting these past service benefits, which were initially unfunded, has enabled millions of Americans to have more adequate retirement incomes.

Employers are required to amortize the unfunded liability for these past service benefits over a period of years, and the overwhelming majority of employers have been able to do so. If employers had been required to pay the entire cost of the past service benefits on the day the plan was established, they could not have afforded to offer past service benefits and American workers would have been the losers. It is important to encourage other employers to establish defined benefit pension plans with past service benefits in the future.

Employers have often improved the benefits under pension plans, for

example by increasing the benefit per year of service for both past and future service or by making postretirement increases in benefits to help offset inflation. These improvements create liabilities, which must be amortized over a period of years. These increases have brought more adequate retirement incomes to millions of Americans, and in almost all cases employers have been able to meet their cost commitments. It is important to encourage employers to continue making improvements in their defined benefit pension plans in the future. Unfunded accrued benefits are a natural part of establishing plans and making benefit improvements, and in most cases they pose no problem.

Problems in Some Plans with Mounting Unfunded Accrued Benefits

In collectively bargained plans and similar plans covering hourly paid workers, it is common to define the monthly benefit at retirement as a fixed number of dollars per year of service, e.g., $50 monthly per year of service. In each new round of bargaining, typically every three years, the employer and union agree to increase this benefit per year, partly to offset inflation. ERISA requires that each increase in liabilities resulting from such amendments be amortized over 30 years. Under some plans the pattern of amendments every three years results in continually adding liabilities faster than they are being amortized.

The problem is not that benefits are being increased - a practice that helps being more adequate retirement incomes and should be encouraged - but that the new liabilities are not being amortized fast enough.

Solution to the Funding Problem

The answer to the problem was actually very simple - just shorten the amortization periods for any new increases in liabilities. Instead of this simple and forthright solution, in 1987 the law was amended to add the "minimum contribution requirement" of Code section 412(l). The minimum contribution requirement has two problems. First, it added complexity and administrative burdens, requiring employers to spend more money administering their plans, money that would be better spent on funding actual benefits or meeting other needs. Second, the requirement has not worked satisfactorily, which is why PBGC now proposes to fix it.

The best solution is still the direct, simple solution: shorten the amortization period for newly created liabilities. I recommend that all increases and decreases in unfunded liabilities arising in the future be amortized over 10 years.[1] Limiting this change in the funding requirements to future changes would prevent any immediate jump in funding costs. In time this change would completely eliminate the problem. In the shorter term, additional funding requirements are probably still needed, because some existing liabilities are now being funded over 30 years. Under my proposal 20 years from now all liabilities would be in amortization periods of 10 years or less. Therefore the change should be accompanied by a sunset provision eliminating the minimum contribution requirement of section 412(l) 20 years after enactment. During the next 20 years the minimum contribution requirement gradually would actually apply to fewer plans each year and would gradually have less effect, since plans would gradually become better funded under the regular funding requirement.

One of the best parts of my proposal is that it would reduce actuarial work and fees. It would create no additional regulatory

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[1]For gains and losses, the present amortization over 5 years usually tends to reduce funding requirements, as PBGC has noted. Changing to 10 years would tend to strengthen the funding requirements for most plans, and would reduce the fluctuation in required contributions.

requirement. It would slightly simplify the work during the next 20 years because the same 10-year amortization requirement would apply to all changes in unfunded liabilities, compared to present rules that require periods of 5, 10 or 30 years for changes arising from different sources. In 20 years the work would be further simplified by completely eliminating the minimum contribution requirement. Meanwhile Congress would have sent a signal to employers that it is moving to simplify administrative burdens instead of continually making them worse. Such a change would encourage employers to establish and maintain plans.

H.R. 3396 addresses the need to strengthen the funding requirements, but it would accomplish this by substantially increasing the complexity and administrative burdens. This would waste resources on the costs of administration and discourage employers from establishing and maintaining defined benefit plans and from granting desirable amendments to improve plan benefits.

Limit Increases in Benefit Guarantees

The maximum guaranteed benefit automatically increases with inflation in wage levels. It has grown from $750 per month in 1974 to $2,556.82 per month ($30,681.84 per year) in 1994. Since the program has mounting unfunded liabilities, it makes sense to freeze this escalation of the guarantees until the program's assets catch up with its liabilities. Such a freeze would generally only affect higher paid employees, who are the ones who receive large pensions. Over a period of years this freeze could become significant in containing the program's soaring costs.

The second change needed to contain the rising guarantees deals with amendments. The statute now provides that the guarantee of increases in benefits resulting from establishing a new plan or from a plan amendment is phased in over five years. The phase-in of new guarantees is often faster than the new benefits are being funded. In addition, the phase-in greatly complicates the computation of guaranteed benefits upon a plan termination, particularly if the plan has had two or three amendments during the last five years. To solve these problems I propose replacing the five-year phase-in with a five-year cliff requirement, guaranteeing no increase in benefits that result from plan changes occurring during the last five years. This change would help reduce future increases in the premium rates, thus encouraging coverage. The change would also simplify the administrative work and reduce administrative expense for both PBGC and employers.

If Congress decides not to replace the five-year phase-in with a five-year cliff rule, it should replace the five-year phase-in with a three-year cliff rule. A three-year cliff rule would, on average, protect about the same amount of benefits and have about the same cost as the present five-year phase-in, but it would substantially reduce the complexity, work and cost of administering plan termination requirements for both the PBGC and employers.

Other Steps to Strengthen Funding and Reduce Administrative Costs

Several additional changes are needed to strengthen the funding of plans and reduce administrative burdens of the funding requirements.

1. Require Recognition of Future Increases in Limits. ERISA requires the actuarial valuation to be based upon actuarial assumptions that "offer the actuary's best estimate of anticipated experience under the plan."[2] Any actuary who assumed that salaries would not increase in the future, for example, would be recognized as violating that requirement and causing plans to be underfunded. But the Code prohibits the

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[2]ERISA §302(c)(3), I.R.C. §412(c)(3).

actuary from recognizing the future automatic increases in the limits on benefits and compensation,[3] with exactly the same underfunding effect. This results in deferring pension costs, causing costs to escalate in later years to make up for the deficit. In addition to being unsound, this requirement increases the cost of actuarial work. The FASB has determined that the Code's prohibition against recognizing the expected automatic increases is not in accordance with generally accepted accounting principles, so a second valuation is required in accordance with generally accepted accounting principals for accounting purposes. The Code's prohibitions against recognizing expected changes should be eliminated.

2. <u>Eliminate the Quarterly Contribution Requirement</u>. Quarterly contribution requirements for plans were added effective in 1988.[4] This requirement ordinarily has no effect on the contributions required for a plan year, except that, to extent that it results in contributions being paid before the end of the year, it reduces the required contribution by interest. The requirement ordinarily has no effect at all in the long run because a dollar paid earlier, together with the interest it earns, reduces the amount that needs to be contributed later. The only time when the quarterly contribution requirement has any significant effect on a plan is in the very unusual circumstance where a plan terminates in a distress termination after the employer has paid part or all of the year's contributions in quarterly installments, and only if the employer would not otherwise have paid its contribution for the year and insolvency of the employer prevents collection of the unpaid contribution. The frequency of this occurrence and the magnitude of contributions involved is minuscule in relation to the total cost of the plan termination insurance program.

   A serious problem with the quarterly contribution requirement is that in many situations it is impossible for the employer to determine the amount of the required first installment in time to pay it. Because there are problems in failing to make a required payment and problems in making a payment that is not required or deductible, employers would like to comply with the requirement if possible, but it is often impossible to know what the requirement is in time to comply. A law that is impossible to comply with is a bad law. Recognizing this, PBGC has proposed to eliminate the quarterly contribution requirement for most plans, a commendable step forward. However, there would still be some plans (particularly frozen plans close to being fully funded) left in the quandary of not knowing, at the time when the first quarterly contribution is due, whether any quarterly contribution is required. The quarterly contribution requirement should be completely eliminated because its burden exceeds its value.

3. <u>Eliminate the OBRA Full Funding Limitation</u>. As enacted in 1976, ERISA contained a full funding limitation[5], which limited the required contributions and the maximum deductible contributions to the amount needed to make the plan fully funded on an ongoing plan basis. OBRA87[6] weakened this requirement by adding an alternative full funding limitation, that limits contributions to an amount that is often less than the amount needed to make plans fully funded on an ongoing

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[3]Code §§404(j)(2), 404(l) prohibit recognizing future automatic increases in the limits under §§415(d) and 401(a)(17).

[4]ERISA §302(e), I.R.C. §412(m).

[5]ERISA §302(c)(7), I.R.C §412(c)(7), I.R.C. §404(a)(1)(A).

[6]P.L. 100-203.

plan basis. In addition to weakening funding, this alternative full funding requirement increases actuarial work and fees, often requiring an additional valuation based upon actuarial assumptions that are different than those used in the regular actuarial valuation. In order to strengthen funding and reduce the costs of administering plans, this OBRA full funding limitation should be deleted.

4. Eliminate the Alternative Minimum Funding Standard. The alternative minimum funding standard[7] allows a plan to be funded ignoring its liabilities determined on an ongoing plan basis. This method, rarely used in practice, is an extremely weak funding method which leaves a plan on the brink of being underfunded on a plan termination basis. This unsound basis should be eliminated from the statute. The elimination would also tend to simplify the statute and eliminate 10 lines on Form 5500 Schedule B.

5. Eliminate the Extension of Amortization Periods. ERISA included a process to request an extension of amortization periods.[8] In the 20 years since ERISA's enactment apparently there has not been a single request for an extension of an amortization period, and none is ever expected. Elimination of this provision and the various cross references to it will remove some of the clutter from the statutes and the related regulations. Eliminating the complex clutter is one element of simplification.

Change the PBGC Premium Rate

Annual PBGC premiums, originally $1 per participant, now consist of a flat rate premium of $19 plus a variable premium of up to $53, a total premium of up to $72.

In the aggregate the amount of premiums are a very small part of pension costs and are not a major problem for employers. However, the premium structure has five basic problems:

1. Premiums have increased with large sporadic jumps. These jumps frighten employers, making them wonder what future jumps they will face in light of reports of PBGC's underfunding. Now PBGC proposes to remove the $72 maximum entirely, creating large (and highly publicized) increases for some employers.

2. The variable rate premiums add administrative complexity and cost, requiring the calculation of unfunded guaranteed benefits using actuarial assumptions that are used for no other purpose.

3. The variable rate premium is more difficult and costly for PBGC to audit than the flat rate premium, and PBGC rarely audits it.

4. The variable rate premium is unfair. Although it is based upon the amount of unfunded vested benefits, which is usually close to the amount of unfunded guaranteed benefits, most employers that pay variable rate premiums usually pose little or no current risk to the program for one of the following reasons:

   (1) Regardless of their unfunded guaranteed benefits, it is impossible for most employers to terminate their plans with any unfunded benefits because that is not permitted unless the employer is in "distress". Most employers are not in "distress".

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[7]ERISA §305, I.R.C. §412(g).

[8]ERISA §304, I.R.C. §412(e).

(2) If a plan terminates with unfunded guaranteed benefits, PBGC is entitled to recover its loss from the employer. Depending on the net worth of the employer, PBGC may recover some or all of the loss. Thus even when there is a loss, unfunded guaranteed benefits may substantially overstate it.

Most of the employers paying variable rate premiums pose no current risk whatsoever to the system, the same as employers that pay no variable rate premium. While it is possible that some of these employers who pose no current risk will eventually pose a risk to the system, most never will. Similarly it is possible that some employers who pay no variable rate premium will eventually pose a risk to the system. The variable rate premium purports to base premiums on the amount of current risk to the system, and it doesn't even come close.

5. The variable rate premium tends to discourage employers from making benefit improvements that would benefit employees and also increase premium rates, even though such improvements ordinarily pose no risk to the system.

It is impossible to develop a variable premium structure that is both completely fair and workable. The least inequitable approach is to spread all of the costs over as broad a base as possible. If premiums are to be limited to the sponsors of defined benefit plans, the best solution is to follow the original approach of having a single flat rate premium rate for all such plans. This method also eliminates all of the complexity and burden of calculating variable rate premiums. For these reasons the variable rate premium should be eliminated, not expanded.

It is anticipated that future premium increases will be needed. In fact, the very notion that guarantee limits that increase automatically each year can be financed with premiums that are not similarly adjusted is absurd. I recommend that the flat rate premiums be adjusted in the future in the same manner as the maximum benefit guarantee. This would eliminate or reduce the need for sudden jumps in future premium rates. Rates that increase a little each year, similar to the FICA taxable wage base and many other costs of business, will not alarm employers. Sudden jumps in the premium rates attract attention and cause concern, discouraging plans. In the long run automatic annual adjustments in the flat rate premium would more than offset the complete elimination of the variable rate premium. But even if variable rate premiums are retained, the flat rate premium should be adjusted annually in order to reduce or eliminate the need for future jumps in the premium rate.

<u>Increase PBGC's Investment Return</u>

The assets held to meet the obligations of the plan termination programs for single employer plans and multiemployer plans each consist of two parts:

1. trust funds derived from assets taken over from terminated plans and
2. revolving funds derived from premium payments.

The 1992 annual report does not disclose what portion of the assets are in each category. The trust funds are invested in equities, corporate and government bonds, and other investments. The revolving funds are invested entirely in U.S. government securities, as required by ERISA section 4005(a). As of 9/30/92 73% of the combined assets were held in fixed maturity securities, 21% were held in equities and 6% were held in real estate and other investments.

Regardless of the source of the funds, all assets are held for the purpose of paying future benefits and expenses. The funds have a positive cash flow and are expected to have a positive cash flow for many years in the future. That means that almost all of the funds can be invested with long-term investment objectives and with little need for liquidity.

The total investment return of equities has exceeded the return of both long-term corporate bonds and long-term government bonds for every one of the 40 most recent 20-year periods (from 1935-1954 through 1974-1993).[9] During the last 68 years the average return of stocks has been approximately double that of bonds.[10] Virtually all investment experts expect that equities will continue to produce higher rates of investment return in the long-term future. The typical large corporate pension fund has approximately half of its investments in equities, in comparison to 21% for PBGC. Increasing the portion of assets invested in equities would be expected to increase the long-term investment return and thus reduce the need for future premium increases to finance the program.

Of the portion of plan assets that are invested in fixed dollar investments, most corporate pension funds have most of this invested in corporate bonds and very little in U.S. government securities, which have lower returns. In contrast PBGC has almost all of its fixed dollar assets invested in U.S. government securities, as is required for the revolving funds. For the portion of PBGC's portfolio that is to be invested in fixed dollar investments, investing more in corporate bonds and less in government bonds would be expected to increase the long-term investment return and thus reduce the need for future premium increases to finance the program.

Therefore section 4005(a) of ERISA should be amended to specify that the revolving funds will be held in trust so that they may be invested primarily in corporate stock and bonds, and Congress should indicate its intent that PBGC's assets be so invested.

<u>Other Changes</u>

The bill includes a variety of other changes. Some of these would help participants and some would harm participants. These are discussed in the Appendix to these comments.

<u>Conclusion</u>

Legislative solutions are needed to strengthen pension plan funding and the plan termination program. If the primary goal is to provide American workers with more adequate retirement incomes, such changes must be made in a way that encourages employers to establish and maintain defined benefit pension plans, and to expand benefits under them. H.R. 3396 needs to be modified as indicated in this statement and its detailed Appendix in order to accomplish its objectives without providing increased regulatory burdens. Without such changes it would discourage coverage and thus harm participants.

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[9] <u>Stocks, Bonds, Bills, and Inflation 1994 Yearbook</u>, Ibbotson Associates, Chicago, 1994.

[10] Ibid.

Statement of Kevin Brogan
Manager, Human Resources
HYDRA-CO Enterprises, Inc.

Before the Committee on Ways and Means
Hearing on H.R. 3396, The Retirement Protection Act of 1993

April 19, 1994

I am Kevin Brogan, Manager, Human Resources, of HYDRA-CO Enterprises, Inc. Our address is 100 Clinton Square, Suite 400, Syracuse, NY 13202-1049. Our telephone number is (315)471-2881.

What We Are Seeking

Our interest in the proposed legislation relates to the portion that would **eliminate "age weighted" profit sharing plans and cross-tested defined contribution plans.** As we understand the proposed legislation, it was intended to eliminate plans that provide huge tax shelters for top-paid key employees, but little for the rank-and-file.

We ask that you restrict the legislation to plans that are top heavy. Top heavy plans are defined in the Internal Revenue Code as those that give top-paid key employees over 60% of the dollar amount of benefits. The HYDRA-CO plan, which gives its top-paid key employees only about 30% of the benefits, is far from being top-heavy by this standard.

If the HYDRA-CO plan were subjected to the legislation as proposed, it would have the **unintended consequence of hurting the rank-and-file.** The legislation would compel HYDRA-CO to revert to a defined benefit pension plan, which is age-related by its very nature—more so than the current defined contribution plan that would be banned by the legislation.

Background on HYDRA-CO and It's Plan

HYDRA-CO is an independent power producer. In 1992, we took our 82 employees out of our parent company's pension and savings plans and replaced those benefits with a single defined contribution plan. To maintain equity, we asked our consultants, Hewitt Associates, to design the plan so that it would come as close as possible to matching benefits expected from the former plans.

A single defined contribution plan designed to emulate a pension allows us to:

- Compete with other employers who have pension plans;
- Avoid the high cost of administering both a pension plan and a savings plan; and
- Provide a plan that our employees can appreciate better because they can see what we contribute, direct their own investments, and watch their accounts grow.

Background on the Proposed Legislation

The proposed repeal of cross-testing was introduced because of perceived abuse by small businesses of regulations designed to prevent discrimination in favor of top-paid key employees. Some insurance companies and mutual funds were touting cross-testing as a way for owners of small businesses to keep a large portion of tax-favored plan contributions for themselves. An article in *The Wall Street Journal* (August 16, 1993) described cross-tested plans as "lush loopholes" for doctors, dentists, accountants, and lawyers.

Concept of Cross Testing

Cross-testing allows employers to do no more than what a common defined benefit pension plan does for older employees. In fact, the HYDRA-CO age-weighted defined contribution plan, which was designed to replace a defined benefit pension plan, provides benefit rates for low-paid employees that are 124 percent of rates for high-paid employees.

Without cross-testing, HYDRA-CO would have to revert to a combination of pension and savings plans that would lower benefits in general and reallocate benefits from lower-paid to higher-paid employees.

Our Current Plan Contributions

The HYDRA-CO plan needs to be cross-tested as a pension plan because, to maintain equity with the former pension plan, contribution rates are expressed as a percent of regular pay that varies by age and past service.

Contribution Rate

Age as of	Years of Service as of December 31, 1991						
January 1	0 to 4	5 to 7	8 to 10	11 to 16	17 to 19	20 to 26	27 plus
Under 35	5%	6%	6%	6%	7%	7%	7%
35 to 39	6%	7%	7%	8%	8%	9%	10%
40 to 44	7%	8%	9%	9%	10%	11%	12%
45 to 49	9%	10%	11%	12%	13%	14%	15%
50 to 54	11%	13%	14%	15%	16%	17%	19%
55 to 59	13%	15%	16%	17%	20%	21%	23%
60 plus	15%	18%	19%	20%	23%	24%	25%

When the HYDRA-CO plan replaced the parent company's pension and savings plans for HYDRA-CO employees in 1992, this contribution table was designed to provide an equitable transition.

Demographic and Contribution Data

Despite the fact that low-paid employees tend to have lower contribution rates due to their younger age and shorter service, their projected benefit rates are higher than high-paid employees. The demographic and contribution data for plan participants in 1992 were as follows.

HYDRA-CO Retirement Plan, 1992

	Low-Paid	High-Paid**	Low/High
Employees	59	23	
Average Age	32.6	41.5	
Average Years of Service	2.6	7.8	
Average Years to Age 65	32.4	23.5	
Compensation ($000)	$1,751	$2,121	
Contributions ($000)	$98	$187	
Average Contribution Rate	5.86%	8.65%	68%
Average Projected Benefit Rate*	4.06%	3.27%	124%

*Percent of W-2 pay, assuming contributions earn 7 percent a year to age 62, when an annuity is purchased based on 7 percent interest and UP-1984 mortality.

**Earned over $63,600 in 1992.

Nondiscrimination Testing Results

Cross-tested as a pension plan, the HYDRA-CO plan passes the general nondiscrimination test with flying colors. The results for 1992 are shown in the following table. In doing the test, basic contributions have been converted to benefits according to assumptions spelled out in regulations: 8 percent interest, UP-1984 mortality, and benefit commencement at age 65. Permitted disparity for Social Security has been added. Participants have been sorted by benefit rate groups, all of which pass the 70 percent ratio test by a wide margin.

Cross-Testing as a Pension Plan

Rate Group	Participants		Percent of Controlled-Group Employees		
Minimum	Low-Paid	High-Paid	Low-Paid	High-Paid	Ratio Test
8.53%	30	3	1.22%	0.25%	492%
7.71%	33	3	1.34%	0.25%	542%
6.98%	36	7	1.47%	0.58%	253%
6.32%	39	12	1.59%	0.99%	160%
5.71%	43	15	1.75%	1.24%	141%
5.17%	46	16	1.87%	1.32%	142%
4.68%	48	19	1.95%	1.57%	124%
4.23%	51	19	2.08%	1.57%	132%
3.83%	52	20	2.12%	1.65%	128%
3.46%	52	21	2.12%	1.74%	122%
3.13%	52	22	2.12%	1.82%	116%
2.84%	54	22	2.20%	1.82%	121%
2.57%	55	22	2.24%	1.82%	123%
2.32%	57	23	2.32%	1.90%	122%
All	59	23	2.40%	1.90%	126%

If cross-testing were repealed, it would no longer be possible to test the plan as a pension plan—even though it was designed to replace a pension plan. The following table shows the results of testing the plan as a defined contribution plan. Several groups of contribution rates, which include disparity permitted for Social Security, fail the 70 percent ratio test.

Testing as a Defined Contribution Plan

Rate Group	Participants		Percent of Controlled-Group Employees		
Minimum	Low-Paid	High-Paid	Low-Paid	High-Paid	Ratio Test
16.00%	1	1	0.04%	0.08%	49%
14.48%	3	3	0.12%	0.25%	49%
13.10%	5	7	0.20%	0.58%	35%
11.85%	19	12	0.77%	0.99%	78%
10.72%	27	13	1.10%	1.07%	102%
9.70%	45	14	1.83%	1.16%	158%
8.78%	48	16	1.95%	1.32%	148%
7.94%	51	19	2.08%	1.57%	132%
7.18%	51	22	2.08%	1.82%	114%
6.50%	52	23	2.12%	1.90%	111%
All	59	23	2.40%	1.90%	126%

Unintended Consequences of the Legislation

If cross-testing were repealed, one way of complying would be to cap the contribution rates of our seven top-paid employees at approximately 13 percent of W-2 pay. This obviously is not an appealing solution. These employees obviously would prefer instead to go back to the pension and savings plans that the current retirement plan replaced.

If we were to revert to the prior pension and savings plans, there would be two effects:

- The value of current accruals for most employees would be reduced because the value of a defined benefit plan is tilted to older, longer-service employees more so than a defined contribution plan.

- The reduction in accruals would be much greater for the rank-and-file than for top-paid key employees.

In addition, we may wish to reinstate five-year cliff vesting because pension accruals for short-service employees are small and do not warrant the administrative burden.

The reduction in benefits for low-paid employees would be almost twice the reduction for high-paid as shown on the following table.

Average Benefit Rate at Age 62

	Low-Paid	High-Paid
Current Plan[a]	4.06%	3.27%
Replacement Plans		
• Pension[b]	1.36%	1.93%
• Savings[a][c]	1.62%	0.89%
• Total	2.98%	2.82%
Change	-27%	-14%

[a]Assumes contributions earn 7 percent a year to age 62, when an annuity is purchased based on 7 percent interest and UP-1984 mortality.

[b]Benefit rate is 1.45 percent of W-2 of pay for an employee with years of service under 10 and 1.75 percent of W-2 pay for an employee with years over 10, reduced by 0.40 percent of W-2 pay up to $16,500 for all employees. Assumes pay growth of 4 percent over prior year.

[c]Contribution of 2 percent of W-2 pay.

In addition to the negative impact that a pension would have on benefit value, there are other considerations.

- The compensation value of a pension plan is not nearly as visible to employees as a defined contribution plan.

- Establishing and administering a pension plan would be very expensive, especially in view of the fact that HYDRA-CO cannot rejoin the parent company's plan because of the need to separate HYDRA-CO as an independent power producer.

Finally it would be a shame if HYDRA-CO and its employees were subjected to a wrenching change due to legislation that does not appear to make any sense in our situation.

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN,
NATIONAL COORDINATING COMMITTEE
FOR MULTIEMPLOYER PLANS

FOR THE HOUSE COMMITTEE ON WAYS AND MEANS
HEARING ON
THE RETIREMENT PROTECTION BILL OF 1993 (H.R. 3396)

April 19, 1994

My name is Robert A. Georgine and I am presenting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans ("NCCMP").

The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted the Employee Retirement Income Security Act of 1974 ("ERISA") in 1974. It consists of representatives of approximately 240 pension and welfare plans, or their sponsors. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

The purpose of my testimony is to warn you that you could create serious problems for the multiemployer plan system, which is currently financially sound, if you add new funding burdens or restrictions on benefit improvements for multiemployer plans.

The Retirement Protection Bill of 1993 (H.R. 3396) (the "Bill") reflects the Administration's considered judgment that existing multiemployer pension plan funding rules are working well and should not be changed. This is in contrast to its proposal to tighten funding rules for single employer pension plans and provide other protections to strengthen the Pension Benefit Guaranty Corporation's ("PBGC") single-employer pension plan guarantee program. This decision regarding multiemployer plans was carefully considered after a thorough examination of all relevant issues and reflection on comments from all sides. The Administration recognized that the benefit security concerns that prompted a call for reform, as embodied in the Bill, relate only to single employer plans and the PBGC's guarantee program for those plans.

Nonetheless, some maverick employer groups, waving the banner of multiemployer pension plan solvency, are seeking to use this legislation as a vehicle to hobble the authority of multiemployer plan trustees over the benefit designs of the plans. Indeed, the Subcommittee on Oversight's report to the Ways and Means Committee on the Pension Funding Improvements Act of 1993 (H.R. 298) includes a provision designed by the Multiemployer Pension Plan Solvency Coalition ("Coalition") that would effectively prevent a multiemployer plan's trustees from adopting benefit increases unless the plan is, and would stay, at least 90% funded. I urge you to oppose any amendment to H.R. 3396 that would impose this so-called "cash-or-collateral" rule, or any similar constraints, on multiemployer plans.

The employers calling for such a rule do not have the best interests of multiemployer pension plans or their participants at heart. Their professed desire to improve the funding of multiemployer plans is really a smoke screen to hide their true purpose. They are really asking Congress to help them to stop providing pension benefits to these employees. The responsibilities of these companies to their employees are matters that should be resolved at the bargaining table -- not by Congress.

A. THERE IS NO NEED FOR ADDITIONAL FUNDING RULES FOR MULTIEMPLOYER PLANS

As you know, ERISA requires the PBGC to operate and fund the multiemployer plan benefit guaranty program independently of the single employer plan program. The multiemployer program is extremely well funded -- indeed, with reserves that are more than three times the estimated guaranty liability, it is probably overfunded. There is no need for additional funding or benefit restrictions. In fact, there is a very real danger that the imposition of additional rules could undermine the health and sound funding of multiemployer plans.

1. Multiemployer Plans and Their Benefit Guaranty Program Are Extremely Well Funded

The reforms enacted in the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA") have been extremely successful in facilitating sound funding in multiemployer plans. MPPAA ensures that employers who withdraw from a multiemployer plan pay their fair share of the benefit liabilities that were promised to the plan's participants and in which plan participants have vested prior to the employer's withdrawal. MPPAA was the subject of long and careful negotiation and compromise by representatives of all affected parties -- the plans, their participants, contributing employers and the PBGC.

In the fourteen years since MPPAA was enacted, the level of multiemployer plan funding has jumped dramatically. In fact, the most recent survey by the Segal Company, a national employee benefits consulting firm, found that, in the past decade, the percentage of multiemployer plans that are fully funded for vested liabilities has increased from 65 to 79 percent of plans. In addition, the survey found that in 1983, the average multiemployer fund was approximately 90% funded and that, by 1991, this percentage had increased to 97%.

The sound funding of these plans is also reflected in the PBGC's multiemployer guarantee program. The PBGC's 1993 Annual Report shows that the multiemployer pension plan program "continues to have growing assets, low liabilities, and positive equity." The multiemployer program's continued financial gains resulted in assets of $407 million, liabilities totaling $131 million for future benefits and nonrecoverable financial assistance and equity of $276 million. That report goes on to state that, as of the beginning of 1991, multiemployer plans had total assets of $161.1 billion and liabilities of $150.3 billion, and that only a minority of these plans were underfunded -- by a total

of about $10.6 billion. The attached graph, excerpted from the PBGC's 1993 report, shows the steady increase in multiemployer plan assets, as compared to liabilities, over the last five years.

Of the 2,000 multiemployer plans, only 11 have received financial assistance from the PBGC since 1980. Moreover, the PBGC has found that future claims based on current underfunding are probable or reasonably possible in only two percent of multiemployer plans and that "current monitoring supports the fact that the program should continue to be in sound financial health."

In response to the strong financial position of the multiemployer benefit guaranty program, the PBGC, in its 1991 report, "The Financial Condition of PBGC's Multiemployer Insurance Program," proposed to Congress that no increase be made in the multiemployer plan premium (currently $2.60 per participant, as compared to up to $72 per participant for a single employer plan), even while recommending that Congress increase the multiemployer plan monthly benefit guaranty levels (from a maximum of $16.25 to a maximum of $24.38 times years of service) to reflect inflation.

The sound funding of the PBGC's multiemployer plan program appears even more clearly when you remember that the maximum monthly per-participant benefit that is guaranteed by the PBGC under a multiemployer plan is far less than that guaranteed by the PBGC under a single employer plan. Thus, the PBGC is ultimately at risk for a smaller proportion of total multiemployer plan benefits than of total single employer plan benefits.

As an example of the financial health of most multiemployer plans, we attach the results of a study of the people represented by the United Food and Commercial Workers International Union ("UFCW"). To analyze the financial condition of UFCW plans, this study used the same screening process that was developed and used by the PBGC in a 1991 study. As you can clearly see, these plans surpassed the PBGC's standards with flying colors.

The existing multiemployer plan rules are working to assure that the benefits promised to plan participants are secure, and the PBGC program backing up those promises is well financed. MPPAA's carefully designed and long-proven provisions should not be disturbed. Such disruption would be clearly unnecessary in light of the current financial health of these plans and their PBGC guarantee program.

2. The Proposed Rule Could Undermine the Current Sound <u>Funding of Multiemployer Plans</u>

Far from improving the funded status of multiemployer plans, a restriction such as the proposed cash-or-collateral rule could undermine their current sound funding.

Especially in the context of collectively bargained plans, pension contributions explicitly reduce future wages. Multiemployer plan contribution rates are fixed by collective bargaining agreements that must receive the support of a majority of the active employees. Typically, the employers offer a set amount, which can be used either for benefits or for wages, at the option of the union acting on behalf of the

employees. The most practical way to encourage plan participants to approve an increase in plan contributions instead of a pay increase is to use part of the increase to improve their benefits. This two-steps-forward, one-step-back process has been used successfully by multiemployer plans to achieve adequate funding levels while encouraging active participants to continue to support the plan.

3. Less Than Full Funding Is Not Necessarily Inconsistent With Financial Health

As the PBGC has expressly stated, "The fact that a plan is underfunded does not mean that a participant's benefits are jeopardized or that the pension insurance program is at serious risk." Indeed, a plan that is not fully funded may, nevertheless, be quite sound financially.

Pension liabilities are typically amortized over a reasonable period of time. This is very much like the common practice of taking out a mortgage to finance the purchase of a home. If the annual amount to be paid off is reasonable and affordable, given the plan's contribution stream, it makes no sense to limit participants' benefits to those that can be fully funded immediately.

B. A CASH-OR-COLLATERAL RULE WOULD BE ESPECIALLY HARSH IN THE MULTIEMPLOYER CONTEXT

Multiemployer plans, because of their unique design and administrative arrangements, would suffer severely from a cash-or-collateral rule.

1. A Cash-Or-Collateral Rule Would Be a Complete Ban on Benefit Improvements

The cash-or-collateral rule, on its face, would permit a benefit increase that reduces plan funding levels below 90 percent, if collateral is provided to secure the liability resulting from the benefit increase. This is not feasible in a multiemployer plan. Such plans are independent of the employers, typically numbering in the hundreds or thousands, that contribute to them. Unlike single employer plans, multiemployer plans have no single employer to which they can look for such security.

2. Increases Are Necessary to Adjust Multiemployer Plan Benefits for Inflation

Single employer benefits are often based on, and automatically increase in proportion to, compensation (*e.g.*, x percent times years of service times the average of the employee's highest three years' compensation). Multiemployer plans, on the other hand, typically provide flat dollar benefits that are not related to compensation (*e.g.*, x dollars times years of service). Thus, plan amendments are necessary to provide multiemployer plan participants with the inflation adjustments needed to make sure that pensions will provide a reasonable level of retirement income. The cash-or-collateral rule could prevent multiemployer plan trustees from doing so.

The proposed rule would also seriously restrict the ability of multiemployer plan trustees to provide adequate benefits to retirees. As noted, the majority of active employees must agree to reduce or forego pay increases in order to increase pension contributions. Participants are more likely to accept that if they are likely to reap some benefit from it, through an increase in their future pensions. Adopting moderate benefit increases for active employees therefore may be the only way the sponsors of a multiemployer plan can obtain the resources to fund benefit increases for retirees. The cash-or-collateral rule therefore would tend to have a disproportionate adverse impact on retirees.

3. Employer Deductions Could Be Unfairly Denied

In addition, legislation enacted in 1987 would deny deductions for employer contributions to a fully funded multiemployer plan. It would clearly be inconsistent and inequitable to require full funding of these plans and then deny employers' deductions for contributions to them.

C. MULTIEMPLOYER PLAN BENEFIT DECISIONS ARE BEST MADE BY PLAN TRUSTEES

As noted, the boards of trustees of multiemployer plans are required by law to be made up 50 percent of union representatives and 50 percent of employer representatives. These trustees are in the best position to determine what, if any, benefit improvements are appropriate in light of the plan's projected contribution stream. Trustees typically determine benefit increases after careful consideration of all factors relevant to their particular fund, including the funded status of the plan, the health of the industry, and the needs of the participants.

As fiduciaries, the decisions of multiemployer plan trustees must be in the best interest of the participants. Clearly, it would not be in the participants' best interest for the trustees to adopt benefit increases that the plan cannot reasonably and responsibly afford. As documented above, experience in the multiemployer plan arena demonstrates that multiemployer plan trustees have acted responsibly.

* * *

CONCLUSION

The so-called MPPAA Solvency Coalition has twisted facts and used disingenuous arguments to try to persuade you that a cash-or-collateral-type rule is necessary. They try to paint withdrawal liability as some sort of unfair threat or punishment for an employer that withdraws from a multiemployer plan. Nothing could be further from the truth. The withdrawal liability rules merely require a withdrawing employer to pay its fair share of the unfunded vested benefits of the plan. It prevents withdrawing employers from dumping the burden of funding benefits that have been promised to their employees and in which their employees have vested on employers that remain in the plan. Similar rules apply in the single employer plan context.

The Coalition also implies that imposition of withdrawal liability is a massive event that will bring an employer to financial ruin. This is ludicrous. Withdrawal liability is structured to be paid over a period of twenty years in annual installments that approximate the annual amount of contributions the employer was making prior to its withdrawal. Thus, in general, withdrawal liability does not represent an expense in excess of what an employer had previously been accustomed to paying.

The Coalition also tries to create the impression that a significant number of multiemployer plans are dangerously underfunded. This is simply not true. As demonstrated above, multiemployer plans are currently extremely well funded and present minimal risk to the PBGC. The plan data the Coalition presents has been manipulated to paint an unrealistically negative picture of the financial health of multiemployer plans. For example, it is unhappily true that the Central States Southeast and Southwest Areas Pension Fund has had declines in its coverage over recent years and has a large dollar amount of unfunded vested benefits. However, the Coalition has failed to mention that the Central States Plan has improved its funding dramatically in recent years from 50 percent fully funded in 1979 to 90 percent fully funded currently. We note that this plan has adopted modest benefit increases from time to time as part of the funding strategy that has resulted in this enormous improvement in the plan's funding.

Restrictions on the ability of plan trustees to make benefit improvements in the best interests of their fund and its participants would, in the long run, undermine the continued financial health of multiemployer plans by making it difficult or impossible to bargain increases to plan contribution rates and by making multiemployer plans less attractive to active participants and their contributing employers. This could shrink the broad contribution base that is essential for the continued viability of these plans.

Further, the proposal advocated by a small clique of disgruntled employers is not representative of the vast majority of employers who accept their responsibilities for pension benefits and do not ask Congress to solve problems that are within the proper domain of collective bargaining.

For these reasons, I strongly urge you to oppose a cash-or-collateral rule or any similar rule.

Thank you for the opportunity to present this testimony.

Attachments

Pension Plan Funding and Solvency

In a 1991 study, the PBGC analyzed the funding and solvency of multiemployer plans. Using the same screening process developed by the PBGC to determine significant risk of plan insolvency, we calculated a series of ratio benchmarks to test the financial condition of UFCW pension plans. Our findings were quite positive.

The first analysis compares the number of actives participants for each retiree (see Exhibit #1). The PBGC is concerned when this ratio falls below 1.5. The only category of UFCW pension plans that fell below this standard was plans with less than 1,000 participants, which as we discovered earlier accounts for only 6,000 participants.

Exhibit 1

Ratio # Of Actives To # Of Retirees By UFCW Plan Participant Size

# Of Participants	Active / Retiree Ratio
< 1,000	1.27
1,000 - 4,999	1.79
5,000 - 9,999	3.19
10,000 - 14,999	3.22
15,000 - 19,999	2.93
≥ 20,000	4.93
National Total	2.67

Another important solvency test used by the PBGC compares plan assets available to cover the present value of total vested benefits (the plan's current legal benefit obligation to participants). The PBGC becomes concerned when this ratio falls below 60%. According to our analysis, the average plan in every asset grouping category was fully funded for current vested benefits (see Exhibit #2).

Exhibit 2

Ratio Of Current Value Of Assets To Total Vested Benefits By UFCW Plan Asset Size

Asset Amount	Ratio Of Assets / Vested Benefits
< $50 million	1.25
$50 - $99 million	1.31
$100 - $249 million	1.18
$250 - $499 million	1.35
$500 - $999 million	1.25
> $1 billion	1.18
National Average	1.25

A third solvency test used by the PBGC looks at the ability of the current assets of the plan to cover annual benefit payments. Again, when this ratio falls below 6.0, it raises a red flag to the PBGC about the financial status of a fund. Exhibit #3 demonstrates that the average UFCW plan in all asset size categories solidly passes this test.

Exhibit 3

Ratio Of Assets To Retiree Benefit Payments By UFCW Plan Asset Size

Asset Amount	Ratio Of Assets To Retiree Benefit Payments
< $50 million	18.26
$50 - $99 million	35.51
$100 - $249 million	19.28
$250 - $499 million	18.05
$500 - $999 million	19.18
> $1 billion	50.54
National Average	22.39

Finally, the PBGC's fourth solvency test compares the plan assets available to cover the present value of retiree benefits. The PBGC is concerned if this ratio falls below 1.0. On average, UFCW pension plans in all asset categories far exceed this standard (see Exhibit #4).

Exhibit 4

Ratio of Current Value of Assets To Retiree Benefit Liabilities By UFCW Plan Asset Size

Assets Amounts	Ratio of Assets / Retiree Benefit Liability
< $50 million	12.07
$50 - $99 million	4.39
$100 - $249 million	2.55
$250 - $499 million	3.16
$500 - $999 million	2.63
> $1 billion	2.43
National Average	7.45

In comparing the UFCW plans to the PBGC's solvency standard, that of employer contributions to Retiree Benefit Payments (see exhibit #5), it appears that all of our plans fall below the safe ratio of 1.75. In fact, over 80% of UFCW plans do fall below this safety measure. However, we believe this particular ratio to be misleading. In cases of overfunded Pension Plans, which is commonplace for the UFCW, employers frequently limit contributions or cease them altogether based on the level of overfunding. As a result a low ratio of employer contributions to retiree benefit payments would typically represent a well funded plan that is in no danger of insolvency.

Exhibit 5

Ratio Of Employer Contributions To Retiree Benefit Payments

Asset Size	Ratio of Contributions/ Benefit Distributions
< $50 million	.98
$50 - $99 million	.84
$100 - $249 million	.95
$250 - $499 million	.89
$500 - $999 million	.89
> $1 billion	.65
National Average	.92

1987-1990. Including plans for which PBGC received notices before 1993, the Corporation permitted completion of about 6,700 standard terminations and returned or disallowed another 1,220 cases that were incomplete or failed to meet legal requirements.

PBGC audits a statistically significant sample of completed terminations to confirm compliance with the law and proper payment of participants' benefits. These audits generally have found few and relatively small errors in benefit payments, which plan administrators are required to correct. To ensure that remedial actions required in certain circumstances do not inadvertently harm plan participants, the Administration's legislative package contains a provision to permit PBGC more flexibility in seeking necessary corrections.

Multiemployer Program

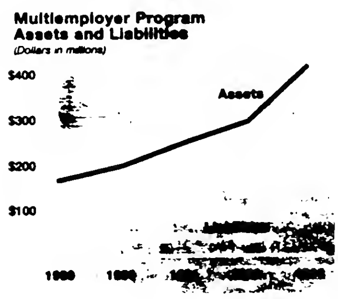
The multiemployer program, which covers about 8.9 million participants in about 2,000 insured plans, is funded and administered separately from the single-employer program and differs from the single-employer program in several significant ways. The multiemployer program covers only collectively bargained plans involving more than one unrelated employer. For such plans, the event triggering PBGC's guarantee is the inability of a covered plan to pay benefits when due, rather than plan termination as required under the single-employer program. PBGC provides financial assistance through loans to insolvent plans to enable them to pay guaranteed benefits.

The significant reforms enacted in 1980 created several safeguards for the program, including a requirement that employers that withdraw from a plan pay a proportional share of the plan's unfunded vested benefits. These safeguards have permitted PBGC to maintain multiemployer premiums at a constant, reasonably low level.

The program continues to have growing assets, low liabilities, and positive equity. The multiemployer program's continued financial gains resulted in assets of $407 million, liabilities totalling $131 million for future benefits and nonrecoverable financial assistance, and equity of $276 million.

Plan Underfunding: Based on data as of the beginning of 1991—the most recent information available—multiemployer plans had total assets of $161.1 billion and liabilities of $150.3 billion. PBGC has determined that a minority of these plans were underfunded by a total of about $10.6 billion.

Financial Assistance: The multiemployer program has received relatively few requests for financial assistance. Since enactment of the reforms in 1980, PBGC has provided approximately $21 million in total assistance, net of repaid amounts, to only 11 of the 2,000 insured plans. Of this amount, about $4 million went to 6 plans in 1993. PBGC estimates that about $110 million, at present value, will be required to make all nonrecoverable future payments to the 6 plans currently receiving assistance and to other plans expected to require assistance in the near future.



STATEMENT OF THE NATIONAL EMPLOYEE BENEFITS INSTITUTE ON THE RETIREMENT PROTECTION ACT OF 1993 (H.R. 3396)

April 29, 1994

The National Employee Benefits Institute ("NEBI") represents Fortune 1,000-sized employers with respect to their employee benefit plans. Most NEBI members sponsor at least one defined benefit pension plan for the benefit of their employees. In addition, most of the defined benefit plans sponsored by NEBI members are well funded.

NEBI members support the interest of the Committee on Ways and Means in strengthening the Pension Benefit Guaranty Corporation ("PBGC") termination insurance for single-employer plans. NEBI members also believe that Congress should enact legislation which improves the funding of underfunded defined benefit plans and insures that the PBGC will be able to pay guaranteed benefits.

GENERAL COMMENTS ON H.R. 3396

Although NEBI supports the efforts of the Committee to strengthen the PBGC termination insurance system, NEBI believes that pension legislation should not be enacted without addressing the impact of the legislation on national retirement policy. National retirement policy should encourage employers to sponsor plans which provide retirement income to employees. Certain provisions of H.R. 3396, however, may encourage responsible employers to terminate their defined benefit plans and discourage the formation of new defined benefit plans. This would result in a continuing decrease in worker's retirement income security. Also, the PBGC termination insurance system would be threatened due to an erosion of the PBGC premium base. Members of the Committee recognize that continuous changes in pension law without regard to the overall effect on the retirement income security of employees must stop.

The Committee should also note that (1) this legislation does not address issues raised with respect to the significant underfunding of pension plans sponsored by federal and state governments, and (2) the problem with the private pension plan system is the lack of encouragements and over regulation designed to seek out potential abuses of any kind, nature or degree.

SPECIFIC COMMENTS ON H.R. 3396

NEBI respectfully submits the following specific comments with respect to H.R. 3396:

1. The PBGC Should Not Guarantee Increased Benefits Unless Appropriate Funding Targets Have Been Satisfied By Underfunded Plans. Current law does not discourage employers from increasing pension benefits provided by underfunded pension plans. In fact, unions and employers routinely negotiate increased pension benefits with reliance on a PBGC guarantee of those benefits. H.R. 3396 allows underfunded plans to continue to adopt benefit increases which are guaranteed by the PBGC, although more rapid funding of the benefit increases is required.

NEBI proposes that benefit increases adopted subsequent to the enactment of reform should not be guaranteed until an appropriate funding target has been satisfied by an underfunded plan. A phase-in of the PBGC guarantee in relation to a plan's minimum funding schedule would be appropriate. This would eliminate the financing of such promises made by some employers at the expense of all other employers.

In addition, NEBI proposes that lump-sum payments from underfunded plans be determined using either a plan's funding assumptions or market interest rates, whichever yields the lowest lump-sum amount. Sponsors of plans which fail to satisfy funding targets should not be permitted to determine lump sums based on subsidized interest assumptions. (It may be appropriate for plans that are not grossly underfunded and targeted by this legislation to use subsidized rates.) The use of individual interest assumptions can increase a plan's unfunded current liabilities and place PBGC at greater risk.

2. Section 415(e) of the Internal Revenue Code Should Be Repealed. Simplification of rules regarding defined benefit plans are necessary to stop the exodus of employers from defined benefit plans and to maintain employees' retirement income security. The Administration has indicated an interest in simplification in its discussion of H.R. 3396. A simplification measure which can be enacted without significant revenue loss would be the repeal of Internal Revenue Code ("Code") section 415(e).

Code section 415(e) limits an employer's deduction for contributions to a combination of pension and defined contribution plans sponsored by an employer. Administration of Code section 415(e) is burdensome. In addition, numerous limitations in the Code which apply to defined benefit plans already significantly restrict benefits before the application of Code section 415(e). These limitations include: (1) recently enacted legislation which limits to $150,000 the annual compensation that can be considered under qualified plans, (2) complicated and extensive nondiscrimination rules, and (3) individual Code section 415 limits on contributions and benefits to qualified plans. Therefore, Code section 415(e) imposes unnecessary administrative burdens on employers without meaningful results.

Another reason to repeal Code section 415(e) is that it greatly impacts on young employees. NEBI has previously demonstrated to members of this Committee the harmful impact of the new $150,000 compensation limit, enacted as part of the Budget Reconciliation Act of 1993, on the participation in 401(k) plans by young employees and those earning just over the highly compensated employee limit. A copy of NEBI's correspondence to Chairman Rostenkowski is attached to this statement. NEBI believes that Congress should consider raising the annual compensation cap because of its harmful effects.

3. H.R. 3396 Should Not Further Decrease Code Section 415 Limits. H.R. 3396 reduces the limits imposed by Code section 415, 402(g) and 408(k) by providing that the cost of living adjustments to these limits will be made in specific increments, rounding down to the next lowest multiple of the increment ($5,000 for 415 limits and $500 for pretax elective contributions). The purpose and effect of the proposal is to raise revenue by delaying cost of living adjustments. Delaying adjustment to the limits further erodes the retirement income security of employees. Instead, legislation should be furthered that focuses on simplification and does not penalize employees for the primary purpose of raising revenue.

NEBI supports legislation proposed by this Committee in the Tax Simplification and Technical Corrections Act of 1993 (H.R. 3419) which would round cost of living increases to the nearest $1,000 for 415 limits and nearest $100 for elective pretax contributions. In addition, if cost of living adjustments are to be simplified, the bill should include the provisions of H.R. 3419 which base the cost of living adjustments on the applicable index as of the close of the calendar quarter ending September 30 of the preceding year -- so that adjusted dollar limits are published prior to January 1 of each year.

4. An Employer's Ability to Satisfy Complex Nondiscrimination Requirements Through the Use of Cross Testing Should Not Be Eliminated. The Internal Revenue Service, in proposed regulations, incorporated the use of cross-testing under the Tax Reform Act of 1986. These regulations were finalized in 1993. Many large employers have and continue to rely on cross testing to satisfy complex nondiscrimination requirements which apply to their qualified plans.

Cross testing applies when a defined contribution plan is tested for nondiscrimination on the basis of the benefits provided. It can be used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis. The Administration proposes in H.R. 3396 to eliminate cross testing because the Treasury Department believes that cross testing allows employers to make allocations to defined contribution plans which unreasonably favor highly compensated employees.

NEBI supports legislation which prevents abuse in defined contribution plans that favor primarily highly paid employees. However, NEBI does not support the complete elimination of cross testing, which will unreasonably harm many employees of responsible employers. NEBI, therefore, encourages the Committee to support proposals which narrowly limit the use of cross testing to prevent abuse.

CONCLUSION

NEBI is pleased to present its statements on H.R. 3396, the Retirement Protection Act of 1993. NEBI hopes that the Committee can refocus the legislation on the funding of pension plans, thereby reducing the PGBC's liability and not attempt simply to raise revenue through provisions which harm the retirement income security of our nation's workers.

This statement is respectfully submitted by Steven D. Huff, Executive Director of NEBI.

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STATEMENT OF ROBERT M. TOBIAS
NATIONAL PRESIDENT
NATIONAL TREASURY EMPLOYEES UNION

Mr. Chairman, I am Robert M. Tobias, National President of NTEU. Thank you for this opportunity to present our views at this hearing. NTEU represents 150,000 federal employees including many at the Pension Benefit Guaranty Corporation, known as the "PBGC." This agency will have primary responsibility for enforcement of much of the proposed legislation. These employees take tremendous pride in carrying out the mission of protecting the private pensions of 40 million Americans. They are dedicated, loyal, hard working, highly competent public servants. Their job is to encourage the continuation of adequately funded defined benefit pension plans; to collect premiums; and, when pension plans terminate, to ensure the timely, accurate and uninterrupted payment of pension benefits to participants and to recover the pension underfunding from plan sponsors and their affiliates.

The proposed legislation would expand the enforcement authority and obligations of the PBGC. Effective implementation requires employees to be more versatile and to assume greater responsibilities. Employees will have to increase their knowledge and upgrade their skills to handle more complex enforcement duties and a larger workload.

Success depends on a positive labor-management component. Unfortunately, like much of government today, PBGC administration and operations stifle employees in their ability to do their jobs. The PBGC bureaucratic organization is layered with supervisor upon supervisor, and clogged with a multitude of departments, divisions and subdivisions. Micromanagement suffocates employee initiative. Endless bureaucratic procedures and red tape are the norm rather than an emphasis on results, quality, customer service and an efficient return to those who pay premiums.

PBGC's own report seeking an exemption from FTE ceilings concedes that PBGC has been critically cited for "reactive enforcement, slow case handling, cumbersome organization, outdated automation systems, lax collection of premiums, disorganized finances, and ineffective management planning."

Even without the duties added with the new proposed legislation, a 1992 OMB report expressed concern

> "about the ability of the existing organization [at PBGC] and staffing patterns to implement and maintain new systems. Sophisticated administrative demands on staff resources have grown markedly over the past few years, similar to demands in the bank regulatory agencies... analytical demands of sophisticated modern processes frequently require the support of professional staff. Simple upgrades of and general raises for the existing staff are not an adequate response to the problem."

To carry out the proposed legislation, and improve the delivery of PBGC services to the pension community and the American workforce, PBGC needs to be reinvented.

A major obstacle to effective operations at PBGC is massive contracting out. PBGC itself reports that expenditures on contract employees have grown nearly eightfold from Fiscal Year 1988 to Fiscal Year 1993 -- from $11 million to nearly $80 million. Contracts now represent almost 60% of PBGC's administrative budget. Most of the work for three basic functions of PBGC -- benefit determinations; benefit payments; and investment of assets -- are now contracted out.

PBGC's own studies show that contracting out costs nearly twice as much as the cost of a federal employee. [**An in-house attorney costs $61 an hour, including overhead. Outside counsel costs $107. An inside actuary costs $50 an hour. An outside actuary costs $99.** Since contractors cannot make administrative decisions, all their work must be thoroughly reviewed. But contracting out not only is inefficient, it takes away career opportunity, and breeds resentment. And, of course, there is the perennial problem of the revolving door: PBGC managers and contract holders backscratching one another; an expansion of contracting out to create future private employment potential; and double dipping where federal retired employees return as contractors.

In another example, last year the PBGC committed over $100 million dollars for a new headquarters building. When NTEU sought to bargain, to make sure that employees could function efficiently and have the resources to do their jobs into the next century, PBGC said "No". Now, the Federal Labor Relations Authority has indicted and is prosecuting the PBGC for this Unfair Labor Practice.

As you might suspect, labor relations at PBGC are strained, and, in fact, have been horrendous for years. PBGC is an agency that fired an NTEU Chapter President for his union activities. It is an agency that refused to comply with an order from the Federal Labor Relations Authority to reinstate that former Chapter President. Instead, the PBGC has squandered hundreds of thousands of dollars dragging this case through the courts.

This pattern of waste of money and resources should be addressed. One of PBGC's responsibilities is "to maintain premiums . . . at the lowest level consistent with carrying out it's [statutory] obligations." Certainly, since the proposed legislation would remove the cap on premiums, it is even more fitting that PBGC reinvent its operations.

NTEU agrees with the notion that PBGC's staffing levels be excluded from the overall FTE ceiling. This would reduce the overall federal government FTE count by nearly 700. This change would be budget neutral, since PBGC is financed through pension premiums and pension trust funds. Contracted out expenditures would be shifted to federal employees. And, significantly, millions of dollars would be saved since contracting out work is far less cost effective.

Administering the proposed legislation will succeed only by involving PBGC employees through their elected representative -- NTEU. PBGC must treat it's employees with dignity and respect. The first step is for PBGC to deal fairly with the Union that represents its employees. PBGC is planning to restructure its insurance operations. By bargaining over staffing and technology, as required under President Clinton's executive order on labor-management partnerships, we can streamline and upgrade PBGC's operations so that it can carry out it's mission.

Pension Benefit Guaranty Corporation
FY 1995 Request

Decision Paper #2 - FTE Exemption

PROPOSAL

Based on the nature of its work and how its operating costs are funded, the Corporation proposes that its staffing levels be excluded from the overall Federal FTE ceiling limitation. Unlike most government agencies, PBGC workload is directly related to elements beyond its control -- business failures and the termination of pension plans. Beyond that, its workload is continuing. Once a pension plan terminates, PBGC responsibility for providing payments to plan participants continues for decades.

PBGC's historical response to increases in workload has been to increase its contracting out because of FTE ceiling limitations -- despite the fact that contracts are sometimes costlier and less efficient. This "Catch 22" posture makes little sense. It is vital that PBGC be able to respond quickly to workload pressures. The Corporation's FTE ceiling is an unnecessary and costly budget appendage that should be dropped as a step to promote better government.

Because the pension trusts PBGC administers are privately established and privately funded, they are not considered public funds even when they come into PBGC's possession. Government corporations, such as PBGC, have been created in response to government programs which are intended to be financed by users and asset investments rather than by general taxpayers. Experience has demonstrated that these kinds of programs do not function effectively under administrative and financial systems designed for tax-supported programs with regular appropriations. Exclusion of PBGC's staffing from FTE ceiling constraints would reduce the Government's FTE count by 677 in FY 1994 and 667 in FY 1995 and yet produce additional flexibility for PBGC to administer its trust fund responsibilities and reduce unnecessary costs.

In the last few years, the management of the PBGC has been subject of substantial criticism. The Corporation has been cited for reactive enforcement, slow case handling, cumbersome organization, outdated automation systems, lax collection of premiums, disorganized finances, and ineffective management planning. Applying the principles of Reinventing Government, a primary focus of our efforts over the last several months has been to upgrade the agency's management. This request represents a significant part of that effort.

BACKGROUND

The PBGC serves as an insurer of plans covered under the law it administers and as trustee for terminated plans. When serving as trustee for a terminated plan, PBGC acts in the interests of the participants and beneficiaries of the plan. That is, PBGC as trustee to a terminated plan is authorized to require the transfer of all or any part of the assets and records of the plan to itself as trustee in order to carry out the particular provisions of the plan in conformance with the regulations of the Corporation and applicable law.

Expenses as trustee include those related to processing, accounting, valuing and managing assets; determining eligibility and benefit levels; and paying benefits. Expenses also include the cost of collection of plan assets such as Due and Unpaid Employer Contributions (DUEC) and the collection of employer liabilities. Litigation is frequently necessary to collect these moneys.

The Corporation has virtually no control over its workload. Major plan terminations in the last few years such as Eastern Airlines (52,000 participants) and Pan Am (35,000 participants) were the direct result of economic difficulties. Also, much of the workload PBGC assumes when it trustees a terminated plan is long-term in nature; that is, it continues until all retirees and beneficiaries in a plan are deceased. Given current life expectancy, in many instances, this could be 30 to 40 years or more. PBGC is currently the trustee of some 1,700 plans and is currently reviewing another 93 for future trusteeship. In addition, the Corporation expects to trustee an average of 87 new termination cases each year for the foreseeable future. Even in the face of this growing workload, the budget policy changes PBGC is requesting - in conjunction with better management and contracting practices - should enable the Corporation to hold its spending in FY 1995 to the OMB allowance levels.

DISCUSSION OF PROGRAM EFFECTS/REDUCTION IN OVERALL COSTS

I. PBGC's Use of Contracts

If the proposal is adopted, PBGC's FTE ceiling would be eliminated and outlays reduced. PBGC's total expenditures in a given fiscal year would likely be less than would be the case under the Corporation's current budget structure, which makes heavy use of contracting because of constraints imposed by artificial FTE ceilings. The Corporation's budget contemplates significant contractual expenditures in such areas as benefits processing, IRM systems development, legal services, investment banking, financial advisory services, and actuarial services.

In the last few years, PBGC has aggressively contracted out programmatic and financial management work, much in the spirit of recommendations by the National Performance Review Task Force. As Attachment 1 illustrates, PBGC's contracts budget has grown from $11 million in FY 1988 to almost $80 million in FY 1993. While internal FTE staffing during this time has risen about 40 percent, the number of participants covered by PBGC's trusteed plans rose 65 percent (see Attachment 2).

More so than most Federal agencies, PBGC has already privatized much of its program functions. Contracts now represent almost 60 percent of PBGC's total administrative budget. Most of three basic PBGC functions - benefit determinations, benefit payments, and investment of assets - are now contracted out. PBGC basically maintains policy oversight and direction over benefit payment and asset investment activities, while benefit determinations are done in-house for just smaller plans covering 28 percent of our liabilities. With the dramatic growth in contracting out, however, we have seen other problems arise. A 1992 OMB report stated:

> "The team has general concerns about the ability of the existing organization and staffing patterns to implement and maintain new systems. Sophisticated administrative demands on staff resources have grown markedly over the past few years, similar to demands in the bank regulatory agencies...analytical demands of sophisticated modern processes frequently require the support of professional staff. Simple upgrades of and general raises for the existing staff are not an adequate response to the problem."

The report also recommended a need for improvement in stopgap contracting and project management. In addition, both OMB and GAO have raised concerns about PBGC's possible overreliance on contracts to complete its mission.

In a 1993 study, the National Academy of Public Administration stated in reference to PBGC:

> "The government corporation has evolved as a pragmatic response to the needs of government programs which are intended to be financed by users, rather than by the general taxpayers and whose expenditures and revenues fluctuate with consumer demand. Experience has demonstrated that government programs with such characteristics cannot function effectively under administrative and financial systems designed for tax supported agencies requiring regular appropriations."

It further recommended that the Corporation be exempted from personnel ceilings imposed by the Office of Management and Budget.

II. Review of Contracting Costs

As a result of these concerns, PBGC is completing an in-house review of its contracting practices. The study examined the need for better contract planning and monitoring, types of contracts that might better suit PBGC's needs, types of services already being contracted out, and whether some major contracting activities are cost-effective. With regard to cost-effectiveness, the review team specifically analyzed about 600 invoices from almost 50 contracts providing litigation support and actuarial services to the Corporation to develop hourly contractor rates. These costs were then compared with the full costs of comparable in-house staff (using OMB A-76 assumptions for fringe benefits and actual figures for overhead). The comparison showed that the contracts were over 100 percent more expensive than if the work was done in-house. Altogether, PBGC spent almost $20 million on legal and actuarial support contracts in FY 1993. Attachment 3 illustrates the full hourly rate comparison for these two activities.

Earlier this year, the program office responsible for benefits administration examined the cost-effectiveness of using on-site contractors under one contract versus PBGC staff to process plans. At that time, there were about 75 contract staff resident in PBGC that processed benefits alongside Corporation staff (now there are over 100). Out of approximately $3.5 million spent on the contract, about $1 million could have been saved if the program office had had additional in-house staff in lieu of the contractors. Altogether, PBGC spent over $20 million on benefits administration contracts in FY 1993.

The bottom line is that staffing decisions have not been made within PBGC on the basis of cost effectiveness. The above three activities where cost comparisons were done constitute half ($40 million) of PBGC's total contract expenditures. On the basis of our studies, a conservative estimate is that if the Corporation is empowered to make cost effective decisions in addressing its contracted out, workload $10 - $15 million in administrative costs could be avoided. [Note: We considered the possibility of assuming the savings by proposing a lower overall budget. Unfortunately, our caseload inventory is already high and growing. For example, the age distribution of our cases awaiting issuance of participant benefit determinations by PBGC shows that about 40 percent of the participants now have to wait as much as 10 years from when a plan is terminated to get that decision. That level of servicing is unacceptable. Therefore, assuming approval of the budget reforms proposed by the Corporation for FY 1995, PBGC would want to apply the savings to reduce its inventory of pending participant benefit determinations for trusteed plans.]

Because the cost of these contracts is borne almost entirely by PBGC's non-limitation budget, which is reimbursed with Trust Funds, there has been no Federal budget impact when the Corporation enters into these contracts. Given the overall FTE constraints, it has been a natural course of action for PBGC to choose to contract out as much additional work as possible.

PBGC is already funding 75 percent of its total costs and 49 percent of its salaries and benefits with Trust Funds. Under PBGC's FY 1995 budget proposal, between 91 and 100 percent of the Corporation's total costs would be supported with private pension trust funds. The PBGC's proposal to exclude its FTE ceiling is merely a logical extension of how its costs are funded. The changes will better equip PBGC management to make sensible decisions regarding the use of in-house staff versus outside contractors. Currently, a decision to spend $1,000,000 on an outside contractor has significantly less budget impact than a decision to hire a half dozen Federal employees. That decision path is simply not good business.

The Corporation recognizes that it has received FTE ceiling increases in previous years from OMB as well as additional funding to meet increased workload. But the process of incrementally adjusting PBGC's ceiling upward or downward once or twice a year is a clumsy and inefficient way to conduct business. PBGC is now staffed at the FY 1993 ceiling of 700 (note that the FY 1994 and FY 1995 ceilings call for reductions from that level). Without further ceiling relief, which becomes more and more difficult in the face of government-wide required reductions, the Corporation will be forced to do even more contracting out of its basic functions at costs higher than if those same functions were performed in-house. The PBGC firmly believes it should be held to a budget, but given the managerial tools to decide the most cost-effective approach to trusteeing its private pension plans.

III. Reinventing Government

The arrangement we seek is consistent with the spirit of Reinventing Government. As the Report of the National Performance Review states:

> "FTE ceilings are usually imposed independently of - and often conflict with - budget allocations. They are frequently arbitrary, rarely account for changing circumstances, and are normally imposed as across-the-board percentage cuts in FTEs for all of an agency's units - regardless of changing circumstances. Organizations that face new regulations or a greater workload don't get new FTE ceilings. Consequently, they must contract out work that could be done better and cheaper in-house."

We recognize that, as a general matter, the government is seeking to reduce personnel costs through more efficient utilization of resources, such as privatization. This is not the case, however, where privatization has gone to the point of diminishing returns. Corporate functions currently assigned to commercial organizations include:

- benefit determination processing for large cases
- benefit payment processing
- litigation support
- actuarial support
- asset investment services
- corporate and industry financial analysis
- IRM systems development

These activities represent a significant portion of PBGC's core mission. As we have detailed, many of these activities could be more efficiently handled with in-house staff.

Beyond that, as part of its program to strengthen management, the Corporation has undertaken a series of steps that advance the purpose of Reinventing Government. These include the following:

A. Benefit Protection Through Anticipatory Programs

Early Warning Program To Keep Pensions Safe - PBGC efforts have historically focused on terminated plans. Through an early warning program, we are monitoring 200 companies with underfunded pensions and taking preventive action to assure that funding and benefit considerations are included in corporate transactions. Already this effort has yielded $85 million in increased funding.

Participant Outreach - We are reaching out to participants in ongoing plans with underfunding to provide them with information on the PBGC and plan funding and to assure them of PBGC protection. We have undertaken this informational campaign in geographic areas with concentrations of underfunded plans. Furthermore, we are planning to conduct a customer survey and hold focus group discussions with participants in FY 1994.

B. Corporate Organization and Processes

Executive Leadership Consolidation - We have consolidated a fragmented departmental organization within PBGC under an executive team concept.

Streamlined Processes - We have completed a corporate-wide organization study, conducted by frontline employees, focusing on specific processes (e.g., how we handle cases) and on the provision of services within the Corporation (e.g., computer services). The study has resulted in flattening the organization and more one-stop servicing. For instance, in the benefits processing area, we are moving away from shifting cases sequentially from unit to unit and towards a single team processing approach. We have also consolidated our efforts and reduced personnel needs in ancillary parts of the process -- the determination of trusteeship, processing reportable events, and passing on appeals of individual benefit determinations.

C. Utilization of Resources

Improved Records Management - We have undertaken image processing of over 330,000 benefit records, and we are modernizing our case records system, integrating it with our financial data base. Most important, we are installing a state-of-the-art premium collection information system. The Corporation receives over $900 million in premiums; its previous manual efforts to collect premiums and the failure to follow-up on unpaid premiums since 1988 have been the subject of substantial criticism. In FY 1993, through a concentrated focus to upgrade our current interim premium collection efforts, we were able to bring in an additional $50 million in premiums. Our collection efforts are now current.

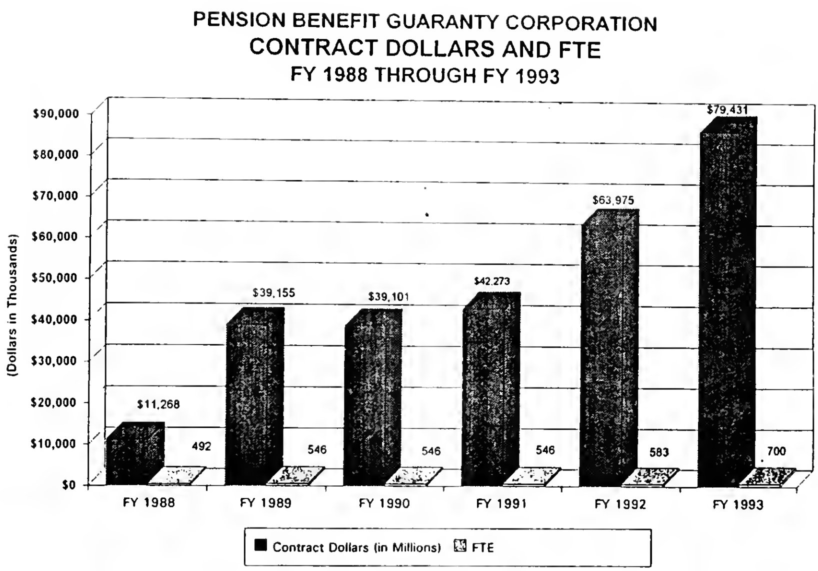
Employee Development - For FY 1994 and 1995, PBGC has budgeted 1.5 percent of its payroll costs for employee development. An in-house review group is being set up to reinvent the Corporation's training programs with an emphasis on better on-the-job developmental experiences and greater participation of PBGC's managers as training instructors.

D. Reducing Internal Administrative Burdens

Budget System - An internal budget management system will be installed shortly to improve the PBGC's monitoring of office expenditures, including the tracking of costs for major contracts, and reduce the overall budget reporting requirements now in place.

Strategic Planning and Directives - The Corporation has revised its strategic planning process to significantly reduce its reporting burden. In addition, an intensive review has begun to reduce PBGC's internal administrative directives.

Removing the Corporation from uneconomic personnel constraints is the last and most important step in improving the management of the PBGC so that it can provide enhanced benefit service to the public. It is a constraint that would not exist in the private sector if a plan did not terminate and PBGC did not have to administer it. The change is basically budget neutral because virtually all increases in FTE or dollars would be charged to PBGC's non-limitation account and reimbursed with its off-budget trust funds.


PENSION BENEFIT GUARANTY CORPORATION
CONTRACT DOLLARS AND FTE
FY 1988 THROUGH FY 1993
(Dollars in Thousands)
$90,000
$80,000
$70,000
$60,000
$50,000
$40,000
$30,000
$20,000
$10,000
$0
$11,268
492
$39,155
546
$39,101
546
$42,273
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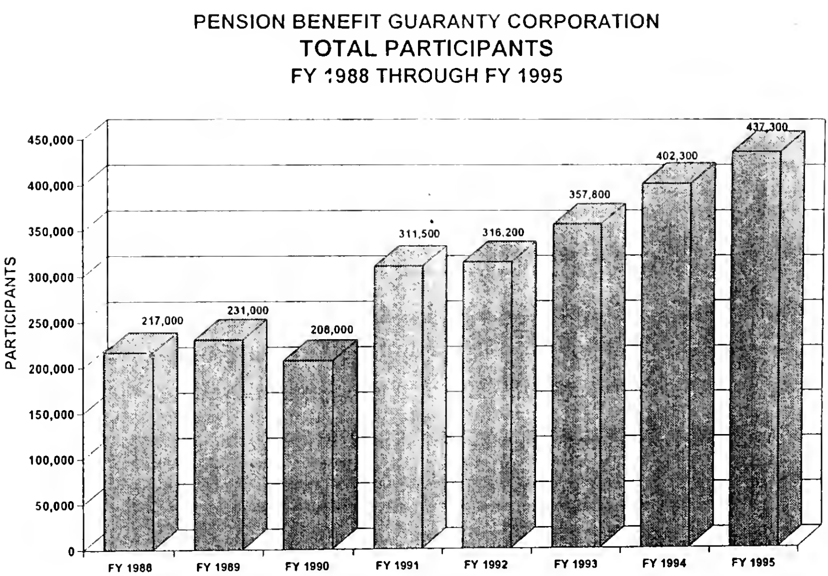
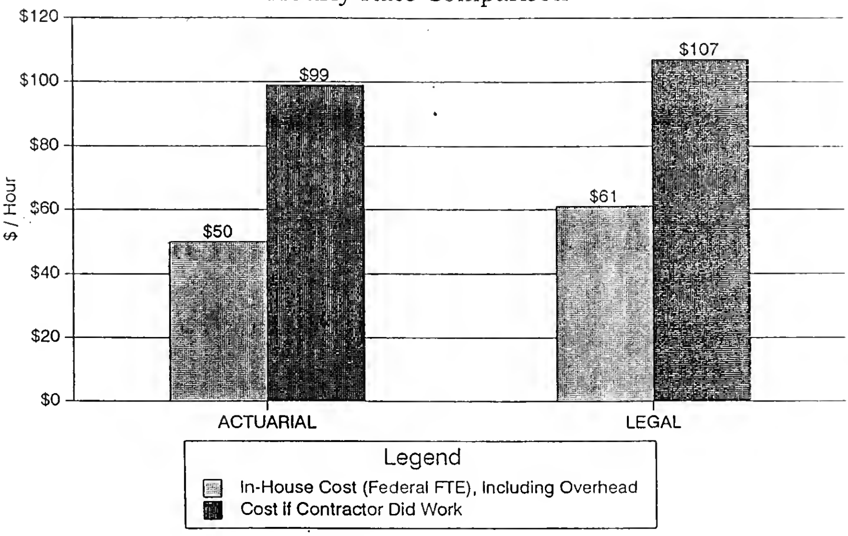
FY 1988
FY 1989
FY 1990
FY 1991
FY 1992
FY 1993
Contract Dollars (in Millions)
FTE

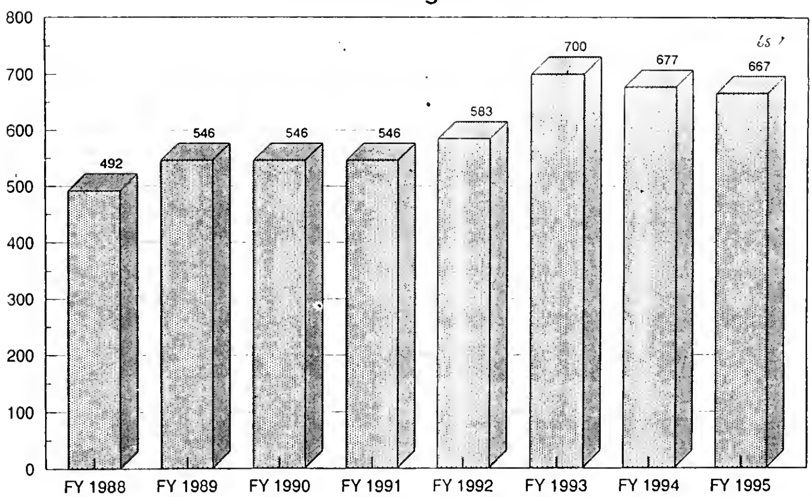

PENSION BENEFIT GUARANTY CORPORATION
TOTAL PARTICIPANTS
FY 1988 THROUGH FY 1995
PARTICIPANTS
450,000
400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
217,000
231,000
208,000
311,500
316,200
357,800
402,300
437,300
FY 1988
FY 1989
FY 1990
FY 1991
FY 1992
FY 1993
FY 1994
FY 1995

IN-HOUSE VS. CONTRACTOR

Hourly Rate Comparison



PENSION BENEFIT GUARANTY CORPORATION
FTE GROWTH
FY 1988 through FY 1995



**STATEMENT BY THE PRINCIPAL FINANCIAL GROUP
TO
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
THE RETIREMENT PROTECTION ACT OF 1993
H.R. 3396
April 19, 1994**

THE ISSUE

The PBGC single-employer fund currently has a large funding shortfall. Despite increases in PBGC premium rates and legislation intended to limit PBGC's liability, the PBGC's financial condition continues to worsen. The Retirement Protection Act of 1993 (H.R. 3396) aims to improve the defined benefit plan system and protect the benefits of plan participants by strengthening the funding rules for underfunded plans; increasing premiums for those plans that pose the greatest risk; enhancing PBGC's compliance authority; and broadening participant disclosure requirements.

BACKGROUND

Congress established the PBGC in 1974 under ERISA to insure, to a large degree, payments made under most defined benefit pension plans. Congress established two programs—the multi-employer program (which currently operates at a surplus) and the single-employer program (which currently operates at a loss). Both programs were to be entirely funded by the premiums paid by plans the PBGC insures. The minimum annual premium has increased from $1 in 1974 to the current $19 per participant, with a possible additional premium of $53 per participant for underfunded plans ($72 maximum premium).

PBGC's Current Status

- The PBGC's deficit for the single-employer fund was nearly $2.9 billion in 1993.

- Total underfunding in single-employer plans insured by the PBGC was $53 billion at the end of 1992.

- The PBGC forecasts that, depending on the level of future losses, its deficit could range between $1.9 billion and $13.8 billion by the end of fiscal year 2003, due to minimal funding of a minority of defined benefit plans and increased benefits due to plan terminations or plant shut downs.

- Potential liability rests primarily with certain industries or specific plan types.

    - $38 billion underfunding is concentrated in the steel, airline, tire manufacturing and automobile industries ($14 billion of this in financially troubled companies).
    - Troubled plans are typically larger ones with "dollars times years of service" benefit formulas (e.g. a monthly benefit of $10 for each year of service with the employer).

- PBGC has sufficient revenues and assets on hand to meet its obligations for many years.

THE PRINCIPAL POSITION

The Principal believes a strong PBGC is essential to the national pension system. It must remain a safety net to insure the benefits of defined benefit plan participants. We applaud the portions of the proposal which help protect the retirement security of millions of workers and retirees. We agree that while the PBGC is not in immediate danger, changes should be made now — while the problem is still manageable. For that reason, we believe the proposed legislation is a step in the right direction. However, we are concerned about some provisions which seem to be unrelated to strengthening the PBGC. We offer the following additional comments and concerns:

1. **Proposals We Strongly Support**

- Strengthen funding rules for underfunded pension plans to require faster funding;
- Prohibit employers from increasing benefits in underfunded plans during bankruptcy proceedings;
- Phase out the current cap on PBGC's variable rate premium over three years;
- Eliminate quarterly premium contributions for fully funded plans;
- Eliminate the 10% excise tax on certain nondeductible contributions;
- Enable PBGC to seek judicial relief short of plan termination when corporate transactions threaten pension funding (e.g., seeking a court order to require a departing controlled group member to remain responsible for pension underfunding for a specific period of time or to post security for part of the pension liabilities);
- Enable plans to file claims against a liquidating sponsor or controlled group member without plan termination;
- Enable PBGC to enforce minimum funding requirements; and
- Improve PBGC's current authority to file liens for missed contributions.

In particular, The Principal supports the goal of strengthening the PBGC's financial condition through tougher funding requirements for underfunded plans. We feel the proposal will, in general, achieve this goal. We are particularly pleased that the proposed funding rule changes will not affect fully funded plans. We are also pleased that the funding rule changes will not affect plans with less than 100 lives.

The Principal also supports prohibiting employers from increasing benefits in underfunded plans during bankruptcy proceedings. We believe the proposal should also prohibit certain plan amendments which do not directly increase a plan's benefit formula, but do substantially increase a participant's benefit. These would include plant shut down benefits, changes to a plan's early retirement provisions, or lump sum benefit options. Each of these provisions could increase a participant's retirement benefit and thus increase the potential liability of the PBGC.

The Principal supports the proposal to increase premiums for those plans most at risk. According to the PBGC, plans at the variable rate cap account for 80 percent of all underfunding yet account for only 25 percent of PBGC's premium revenue. Phasing out the cap on the variable rate premium will provide strong financial incentives for underfunded plan sponsors to improve their funding levels. We strongly support the recommendation to retain (or lower) the flat premium rate of $19. Plan sponsors of fully funded plans cannot—and should not be asked to—bear repeated premium increases. Each time the base rate premium has increased, more sponsors of fully funded plans have terminated their plans, resulting in less pension coverage nationwide and further pressure on the PBGC. Requiring plan sponsors of underfunded plans to take more responsibility for their underfunding is highly appropriate.

2. **Proposals Requiring Clarification**

- Transition rules to ease the impact of the new funding rules;
- Establish new reporting requirements to provide information on seriously underfunded plans to PBGC;
- Protect the interests of participants who cannot be located upon plan termination by requiring the plan sponsor to transfer sufficient assets to pay the participants' benefits to the PBGC;
- Specify uniform assumptions for calculating a plan's minimum funding contribution;
- Specify assumptions to be used to calculate participants' lump sum benefit payments; and
- Round dollar limits for cost of living adjustments.

The Principal questions whether the new funding rules should be phased in over a transition period. This sort of transition rule is a great example of why maintaining a pension plan is so complicated. We believe it is appropriate to consider applying the funding rules in 1995 (without a transition period) and then let plan sponsors apply for a waiver to the IRS of a portion of the funding requirement under the waiver rules as currently in effect.

We support the idea of additional PBGC reporting requirements but believe there will likely be noncompliance with the new rules. Employers, particularly those owned by foreign companies, may not know all the members of the controlled group and may not know if a reportable event has occurred. Also, a single service provider may not provide plan services (actuarial valuation, recordkeeping, etc.) to the entire controlled group. Therefore, the service provider will not be able to monitor the plans and determine if a reportable event has occurred. This will likely result in unintentional noncompliance by some plans.

The proposal to specify the assumptions used to calculate the plan's minimum funding contribution concerns us. Enrolled actuaries curently have an obligation to choose reasonable assumptions when calculationg the minimum funding level. As a result, we question whether it is necessary to place additional restrictions on the selection of actuarial assumptions.

We believe the proposals regarding lump sum distributions and rounding cost of living adjustments are separate issues. Neither proposal addresses the issue of improving plan funding. We are particularly concerned about the single sum distribution proposal since it impacts all defined benefit plans and requires plan amendments. Before we can support this item we need more information about using the 30 Year Treasury Rate. Is it averaged over time? Can the rate on the first day of the plan year be used? As for the proposal to round the cost of living adjustments, we question whether a provision designed to hold down the tax expenditure for qualified plans should be included in a PBGC funding proposal.

3. **Proposals We Cannot Support**

- Add a plan solvency rule requiring underfunded plans to have enough liquid assets to pay at least 3 years of benefits;

  We have several reservations about the proposal to require a plan to hold cash equal to three years' worth of payments (based on the last 12 months). First, a solvency rule based on payments for the prior 12 months will not ensure adequate assets to pay future benefits. Instead, any solvency rule should be based on the plan's expected benefit payments. Second, we question whether Congress should dictate to plan sponsors how to invest plan assets. The solvency rule may cause plan sponsors to invest more assets in low-yielding instruments than necessary, resulting in reduced returns and higher contribution requirements. Instead, we believe the DOL can ensure that plan sponsors and trustees have sufficient assets on hand to pay benefits through enforcement of ERISA's fiduciary prudent person rule. If some modification is really needed, we suggest guidelines requiring plan sponsors to take into account expected benefit payments when establishing asset allocations.

- Broaden disclosure of information for participants and retirees on their plan's underfunding and the limits of PBGC's guarantee through an annual plain-language explanation of their plan's funding status; and

  The Principal supports the goal of educating participants about their retirement benefits and preparing them to make better financial decisions. We believe each plan sponsor should provide participants with information about their plan benefits and explanations of the PBGC's guarantee of those benefits. However, we question whether increasing the disclosure requirements to participants about the plan's funding status will improve the level of plan funding. Since participants generally have no say about a plan's funding level, it is hard to see that this will do much to solve the core problem of plan underfunding.

- Eliminate cross-testing of defined contribution plans on a benefits basis.

  We support the concept of cross-testing defined contribution plans on a benefits basis and feel it is an important plan design option. It has opened up some new plan design options and is bringing more employers (and members) into the private pension system. While some plan sponsors may use this to skew benefits in favor of the highly paid employees, the majority use it to provide non-discriminatory benefits to all their employees. If change is needed, we favor modification of the current rules rather than outright elimination. In addition, we strongly oppose the provision that would apply these changes retroactively to plans established after September 30, 1993. Any modifications made to the current rules should apply prospectively for all plans.

SUMMARY

The Principal believes a strong PBGC is essential to the national pension system and must remain a safety net to insure the benefits of plan participants. In general, we support the proposal's efforts to better coordinate the methods of determining minimum funding requirements and actual plan termination liability in order to reduce the amount of underfunding at plan termination. We also support efforts to place more responsibility on employers and employees for establishing affordable benefits. However, we do have reservations about several of the proposed changes and hope that Congress will consider carefully whether the changes will indeed achieve the goal of improving the financial status of the PBGC.

Information About The Principal Financial Group

The Principal Financial Group is a family of insurance and financial services with assets of more than $44 billion. Its largest member company, Principal Mutual Life Insurance Company, is currently the fourth largest life insurance company in the nation ranked by premium income.

The Principal Financial Group serves 703,000 individual policy holders, more than 74,000 group employer clients, 33,000 pension contractholders and 62,600 mutual fund shareholder accounts. In all, 7.6 million customers (businesses, individuals, and their dependents) rely on the companies of The Principal Financial Group for their financial services needs.

For More Information

Questions or comments may be directed to any of the following employees of The Principal:

Stuart Brahs, Vice President — Federal Government Relations: (202) 682-1280

Larry Zimpleman, Vice President — Pension Services: (515) 247-5752

Jack Stewart, Assistant Director — Pension Services: (515) 247-6389

TESTIMONY OF JAMES H. SMALHOUT
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
APRIL 19, 1994

My name is James H. Smalhout. I am an economic researcher who has spent the past eighteen months writing a book about securing private pension obligations. My work on this project began last year during a one-year appointment as a guest scholar at the Brookings Institution. Currently, I am a visiting fellow at the Hudson Institute. My research is funded entirely by grants from private philanthropic foundations.

The purpose of my project is to examine the problem of how to provide workers with adequate security for their private pension income while avoiding the classic insurance problems of adverse selection and moral hazard. In addition, I am preparing several quantitative chapters that evaluate the financial condition of our private defined benefit system and estimate the value of insurance currently provided by the Pension Benefit Guaranty Corporation. The project will conclude by comparing benefit security arrangements in nine countries.

I have come here today to advise this Committee not to proceed with the approach proposed in the draft Retirement Protection Act. I believe that it would not resolve the fundamental defects in the ERISA termination insurance program and could even make some of their effects more costly. At the end of my statement, I will briefly discuss a different approach that would be capable of resolving these problems. The opinions that I am expressing are my own and they should not be attributed to the Hudson Institute, its trustees, officers or other staff members or to organizations that support its programs.

Where the Retirement Protection Act Goes Wrong

By emphasizing more stringent minimum funding requirements without effectively restricting the growth of unfunded pension liabilities or the ability of portfolio managers to make risky investments, the Retirement Protection Act would place substantial numbers of jobs in jeopardy and create new risks for the PBGC. Almost every administration since ERISA was enacted has attempted to raise the minimum funding requirement without addressing these other needs. Like the Retirement Protection Act that is now before you, all of these efforts were misguided because they ignored economic principles that have been developed in the pension and financial literature for a generation. In light of the potentially damaging consequences of this approach, it can be described as nothing less than ***pointless retribution***.

Placing heavier contribution requirements on financially weak sponsors will increase the probability of default on unfunded pension promises. To understand the principle at work here, consider the case of a plan sponsor with a net worth of $20 million and an unfunded pension liability of $100 million. If a new funding standard were adopted that required the company to reduce the unfunded pension liability by $10 million, what would happen? First, half of the company's net worth would be eliminated putting the firm that much closer to liquidation. The pension fund's portfolio managers also would have a clear incentive to adopt high risk investment strategies in an attempt to help the firm gamble for redemption. If the risky investments appreciate, the company might gain a new lease on life. The investment gains could be used to reduce funding requirements in the future. If there were losses, the PBGC eventually would be left holding the bag. In the meantime, the company can go on making more empty promises to its workers. In all likelihood, they would be paid by the insurance fund. A very similar pattern was repeated many times by savings & loan institutions before the recent federal bailout of that industry.

The most humane way of reigning in the runaway growth of unfunded pension liabilities is not to force marginally liquid companies to put more money into their pension plans, but to stop them from making retirement promises that they cannot afford to keep. To protect taxpayers from eventually having to pick up the tab for these well-documented excesses, the liabilities should be frozen. By addressing the problem by means of a liability freeze, workers would receive far greater job and pension security while the employer took steps to put its financial house in order. At the same time, workers would be protected from the build-up of nonguaranteed pension promises that would have been permitted with the more limited freeze on the ERISA guarantee. Parenthetically, such a freeze on the guarantee was proposed by the Bush Administration one year before it left office.

Accepted principles of corporate finance also argue for investment restrictions if financially shaky sponsors will be required to reduce their unfunded pension liabilities. To prevent the level of risk of the pension plan and its sponsor from increasing after the adoption of more stringent funding standards, the portfolios of poorly funded plans sponsored by these companies should be limited to investment grade bonds[1] until the sponsor-plan combination can prove that it has become solvent. At that point, equity investment could be permitted. However, if the value of assets ever fell to the point where it just equalled the guaranteed benefit obligation all equities would need to be sold in order to purchase a portfolio of investment-grade bonds that would match the duration of plan liabilities.[2] With such a

restriction, plan participants would receive much more effective protection against substantial benefit losses that occur even with PBGC insurance. The probability of termination losses is linked to the considerable credit risk associated with this type of employer as well as the interest rate risk that characterizes investment markets in general.

The Winners and Losers of Pension Insurance

In recent years, wider understanding has developed concerning the extent of the subsidies involved with the current pension insurance program. The Office of Management and the Budget provided estimates of the value of PBGC insurance in the last two editions of the federal budget and there have been several other projects, including my own, designed to achieve better approximations of this value. Every objective study of this question has concluded that a huge gap exists between the value of the insurance and the premiums that have been charged by the agency. Even though the Retirement Protection Act makes an attempt to narrow this gap, it still would remain very large for virtually all tax-qualified defined benefit plans.

Federal pension insurance reinforces firms' incentives to underfund a pension plan because workers place much greater faith in otherwise hollow pension promises when the U.S. Treasury stands behind them. Systematic underfunding has been particularly noticeable in collectively bargained pension plans, in which benefits are renegotiated upward roughly every three years. Although these increases are predictable, they cannot be funded in advance under current law and are not reflected beforehand in the sponsor's financial reports. This pattern of behavior represents another example of the classic insurance problem known as "moral hazard".

Unfortunately, the ERISA termination insurance program also suffers from another insurance problem known as "adverse selection". Adverse selection occurs in systems where premiums are not completely adjusted to reflect risk. Mispriced insurance provides high-risk firms with the incentive to stay in the system while low-risk firms will leave unless participation is compulsory. Concern about adverse selection was clearly evident when two noted financial economists recently observed:

> "Ultimately, the United States could be left only with bankrupt defined benefit plans with the benefits financed directly by taxpayers."[3]

For its part, the nonpartisan Congressional Budget Office reported:

> "far-sighted, fiscally sound premium payers will not voluntarily subsidize the pension costs of their competitors indefinitely. Instead, they will terminate their plans...A voluntary federal insurance system that relies heavily on subsidies from one insured firm to another is probably destined for a federal bailout."[4]

The growing popularity of defined contribution plans coupled with the simultaneous decline of defined benefit plans over more than a decade is consistent with the impression that healthy plan-sponsor combinations have been deserting the program.

The nation's recent experience with deposit insurance has demonstrated beyond any doubt that misguided federal policies affecting the financial system can impose an awesome burden on the economy. Without significant change in the pension area the adverse effects could be felt for a very long time. Trends beginning in the early 1970s suggest that future retirees will be far less likely to benefit from the current pension insurance program. Not only is a declining proportion of today's younger workers covered by defined benefit pension plans, this same group also can expect lower lifetime earnings than people retiring in the 1980s and 1990s. Meanwhile, workers who are now young will be exposed, as taxpayers, to large contingent liabilities attributable to the PBGC for many years. In terms of social equity, a deplorable imbalance therefore has emerged which threatens to produce a large intergenerational transfer of wealth from the less well off to their relatively more prosperous predecessors.

How large is that transfer likely to be? There are many indicators of the ultimate size of this problem but none of them are very precise. The very substantial gap between premiums that have been charged by the PBGC and the actual value of the insurance provides one indicator. Another useful benchmark is the small proportion of that insurance value that has been recognized in the accounts of the PBGC. Additional insight can be gained from the interest rate risk implied by the relationship between the duration of pension assets and liabilities.[5] Finally, the size of the pension system itself serves as a reminder of the stakes involved should conditions deteriorate seriously.

Only a relatively small minority of the labor force benefits from this arrangement. Chart 1 reports that 42.4 million workers had private pension coverage of some sort in 1990.[6] Of this number, 26.3 million were covered by a defined-benefit plan but only 21.4 million had vested in at least one

defined-benefit plan.[7] As a result, only 16.9% of the total labor force received greater benefit security as a result of the ERISA termination insurance program.[8]

Who gains from this arrangement and by how much? The value of the backup guarantee to individual participants is directly related to the vested benefits that they have accumulated in one or more pension plans. Based on this factor as well as recent trends in earnings and pension coverage, it is possible to describe the type of worker most likely to gain significantly from the program. More often than not, that worker is male, over 50, working in a relatively high-paying job for an employer he has served for a long time, and living somewhere in the North Central or Northeastern part of the country.[9] From these results as well as the well-documented trend in favor of DC plans, it seems reasonable to believe that perhaps a third of all workers actually covered by PBGC-insured pension plans can expect ever to have substantial guaranteed benefits.

If the ERISA termination insurance program disappoints for providing improved benefit security only to a relatively small proportion of the working population, it also accentuates the inequities of America's pension system by guaranteeing benefits that greatly exceed available benchmarks for average and socially minimal retirement income. In 1993, the maximum benefit guaranteed by the PBGC stood at $2,420 a month, or $29,250 a year. As Chart 2 depicts, this produced a government-guaranteed retirement income of as much as $42,796 in that same year.[10] Combined maximum guaranteed benefits amounted to 316% of the average combined level of private pension income[11] and social security benefits.[12] The same combined maximum was 822% of the minimum retirement income provided by the federal government under the Supplemental Security Income (SSI) program.[13]

A Fair and More Effective Response

The Retirement Protection Act represents an unstable compromise between political forces that want to rein in the truly massive contingent liabilities in this area and those who believe that the best interests of working people are served when no restrictions are placed on firms to make additional pension promises--regardless of the employer's ability to keep them. A prerequisite for avoiding the gathering crisis that faces the pension insurance program is a recognition of the scale of risk shifting this makes possible and the need to end it. Confusion, misunderstanding and simple parochialism has produced round after round of pension legislation that actually increased risks to the PBGC insurance fund. This particularly applies to the repeated attempts to adopt more stringent minimum funding requirements unaccompanied by restrictions on the investment policies of severely underfunded plans.

Three tools are available that together would stop companies from making promises that send misleading signals to workers and could only be kept at the expense of the insurance fund. These tools consist of: a stop-loss mechanism in the form of a freeze on benefits promised by inadequately funded pension plans; a market-based solvency test involving mandatory private insurance; and, effective levels of coinsurance.

Unreasonable risks to the insurance fund could be avoided if benefits simply were frozen when asset values become inadequate to cover them. However, pension liabilities, unlike bank loans, are imprecise quantities and can be estimated only within a wide range of probability. Making this situation even less tractable, confusion is rampant within the pension community concerning proper assumptions to use for measuring a benefit obligation. The controversy which would surround virtually any reasonable set of actuarial assumptions used to estimate these obligations therefore would make it difficult, if not impossible to implement a benefit freeze by itself.

The stop-loss mechanism therefore would need to be complemented by an additional tool in the form of a market-based solvency test. A reasonable test would require sponsors of unsecured private DB pension plans to maintain AAA or AA credit ratings from at least two of the three major rating agencies (i.e., Standard & Poor's, Moody's and Fitch). Lower rated sponsors would be required to secure their pension obligations by means of a guarantee from an insurance company consistently meeting a AAA standard of creditworthiness. If the combined creditworthiness of a pension plan and its sponsor were so weak that pension insurance could not be obtained, then benefits would be frozen. By relying on the collective financial and actuarial judgments of the insurance industry among others, this approach would relieve public officials of the responsibility--one they have not been able to perform effectively--for defining precise funding standards.

Taken together, the stop-loss mechanism and the market-based solvency test would produce a *triage* system for DB pension plans. A first group of healthy plans would immediately exit the government-run program to enter new private insurance arrangements. Meanwhile, a second group of less healthy plans eventually would become creditworthy enough to enter the private system after their urge to make false promises had been thwarted by a temporary freeze on benefits. However, the investments of any plan in this category should be restricted to investment grade bonds until it qualifies for private

insurance. At that point, equity investment could be permitted but the guaranteed benefit obligation should be hedged using a well-established method known as "contingent immunization". So long as plan assets exceeded the guaranteed benefit obligation, equity investment could continue. However, if the value of assets ever fell to the point where it just equalled the guaranteed benefit obligation all equities would be sold and a portfolio of investment-grade bonds would be purchased to match the duration of plan liabilities.[14]

Finally, the third group of plans could never be expected to satisfy a market-based solvency test. For plans in this group, the approach outlined here would amount to a "termination without termination". Although the PBGC would not actually trustee these plans before the sponsor liquidated, benefits would remain frozen permanently. Contributions could continue at past levels and pension investments also would be restricted to investment-grade bonds.

The third tool, effective levels of coinsurance, is essential to resolve the problem of moral hazard and necessary and to put a reformed termination insurance system on a sound financial footing. Even with the ERISA guarantee, large numbers of workers remain exposed to substantial losses when their pension plans terminate because benefits are frozen in nominal terms at that point. This same problem confronts many more plan participants, even those with vested benefits, when making routine employment changes anytime before their last year at work. As much as 90% of the value of promised benefits can be lost when coverage ceases due to either of these events. In view of widespread mobility in the labor force, an important goal for retirement income policy should be to protect workers from these losses. This objective could be achieved if employers were obligated to provide a reasonable measure of projected benefits secured by a guarantee from a properly-designed termination insurance fund.

Having established this as a first principle, it is important to recognize that even the minimal estimate of the employer's obligation often is seriously understated using currently accepted accounting and actuarial practices. This situation is dangerous for workers because inappropriate choices between saving and consumption can be made in response to the misleading signals that are communicated to them. If workers want to avoid the risks associated with poorly funded pension plans, they need to take the necessary steps to avoid them. In fact, workers can achieve additional protection against this source of risk by negotiating a greater proportion of total compensation in the form of cash to be contributed to an underfunded pension plan or, alternatively, to a defined contribution arrangement.

Can benefit security be improved without exposing taxpayers to major new risks? Here there are grounds for optimism. Protecting workers against post-termination erosion of pension wealth represents the linchpin of a sound approach to coinsurance. In turn, adequate coinsurance represents an essential safeguard against some of the more destabilizing influences created by this poorly designed insurance system.

Before ERISA, benefit security could have been delivered by severing the link between the sponsor's financial health and the condition of the pension plan. To accomplish that objective, unfunded pension liabilities simply could have been prohibited and contributions could have been transferred to financially solid insurance companies, mutual-fund managers or bank trust departments. Instead, a bankruptcy-for-profit scheme was introduced. Its perverse incentives for managers and workers alike has encouraged continuing financial mayhem in the back alleys of the nation's capital markets. More and more, the effects are becoming obvious to the public. To restore some semblance of order now, a slightly more complicated framework will need to be imposed. The costs of past mistakes unfortunately cannot be avoided. However, better policies can be prevent them from growing larger. For that to happen, policymakers must be willing to break with past approaches and focus in a serious way on this important issue.

Clearly, private financial guarantors now are capable of assuming major responsibilities for securing retirement promises made to workers outside the main federal entitlements of social security, medicare and the retirement systems for federal employees. With time, they can be expected to assemble all of the resources necessary to do the work that the PBGC now does and do that work far more effectively. The ultimate effect of this change together with the more effective credit analysis and surveillance that would ensue would be to prevent companies from making promises to their workers which could only be kept at the expense of the insurance fund.

This program clearly has the potential to impose major budgetary costs on the federal government sometime during the first quarter of the next century. America's pension insurance system urgently needs to be redesigned to manage risk, not to compound and shift risks which have been allowed to grow without effective controls.

Footnotes

1. The suitability standard for bond investments also would need to recognize the risk of downgrading. Protection against this possibility can depend on appropriate terms in the indenture agreement. With respect to the credit ratings themselves, a "BBB" represents the lowest investment quality grade. A "BBB" rating indicates adequate capacity to pay interest and repay the principal of the debt in question. However, adverse economic conditions or otherwise changing market developments are more likely to weaken that capacity than would be the case for higher rated debt. Lower rated debt in the "BB", "B", "CCC" and "CC" categories is considered speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. See *Standard & Poor's Debt Ratings: S&P's Corporate Finance Criteria.* New York, NY: Standard & Poor's Corp., 1991, p. 7.

2. See Robert C. Merton and Zvi Bodie (1992), "On the Management of Financial Guarantees." *Financial Management*, Winter, pps. 87-109.

3. See Zvi Bodie and Robert C. Merton (1993), "Pension Benefit Guarantees in the United States: A Functional Analysis," in *The Future of Pensions in the United States*, ed. R. Schmitt. Philadelphia, PA: Pension Research Council at the University of Pennsylvania, p. 208.

4. See Congressional Budget Office (1993), *Controlling Losses of the Pension Benefit Guaranty Corporation.* Washington, D.C.: U.S. Congress, p. 5.

5. Duration is a measure developed to indicate the interest rate risk of fixed income investments. It represents the average time required for the investor to receive the investment principal as well as the interest on it. It is similar to maturity, except that maturity only considers the timing and the amount of the final payment of a bond. The significance of duration is that as it increases the volatility of investment returns also increases with respect to changes in the general level of interest rates. See Arthur Williams III (1987), "Performance Evaluation in Fixed Income Securities," in Frank J. Fabozzi and Irving M. Pollack, *The Handbook of Fixed Income Securities (2nd edition).* Homewood, IL: Dow Jones-Irwin, p. 773.

6. See U.S. Department of Labor. *Private Pension Plan Bulletin: Abstract of 1990 Form 5500 Annual Reports.* (Number 2, Summer 1993). Table A2, "Total Covered Workers"" p. 6.

7. The 26.3 million private-sector workers covered by a DB plan consist of workers covered only by a DB plan as well as workers covered by both a DB plan and a DC plan during the 1990 fiscal plan year. The 21.4 million workers with PBGC protection include active participants who were either fully or partially vested plus, the number of separated participants with a vested right to benefits. It should be noted that the total with PBGC protection includes double counting of workers vested and/or covered by plans sponsored by more than one employer. It is not possible to determine the extent of double counting. See U.S. Department of Labor, *op. cit.*, pps. 6-7.

8. For labor force data reported in Chart 1, see *Labor Force Statistics, 1971-1991.* Paris: OECD, 1993. Table II, United States as well as *Social Security Bulletin: Annual Statistical Supplement, 1992.* (1992) Table 3.B1, p. 121 and U.S. Department of Labor, *op. cit.*, p.6.

9. See John R. Woods (Fall 1989). "Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings from the 1988 Survey of Employee Benefits," *Social Security Bulletin*, pps. 2-19.

10. The maximum social security benefit of $13,546 in 1993 assumed that the worker earned the maximum taxable wage for an entire 35-year career and retired at age 65 in that same year. See *Social Security Bulletin: Annual Statistical Supplement, 1993.* (1993), Table 2.A28, p. 58.

11. See John A. Turner and Daniel J. Beller (eds.), *Trends in Pensions 1992.* Washington, D.C.: U.S. Government Printing Office, 1992, Table 10.10, p.247.

12. See *Social Security Bulletin* (Fall 1993), Table 1.B2, p. 114.

13. SSI is a means-tested supplement to social security financed from general revenue. A single person, age 65, with *no* "countable income" and with "countable" assets of less than $2,000 is entitled to the full, federal SSI payment of $5,208 per year. Individual states may supplement the federal amount. See Social Security Administration. *Social Security Handbook 1993.* 11th ed. Washington, D.C. U.S. Government Printing Office, 1993. pps. 356-7, 392-4.

14. Contingent immunization is similar to a stop-loss order. See Robert C. Merton and Zvi Bodie (1992), *op. cit.*

CHART 1

Benefit Security and the Labor Force: 1990
(Workers in thousands)

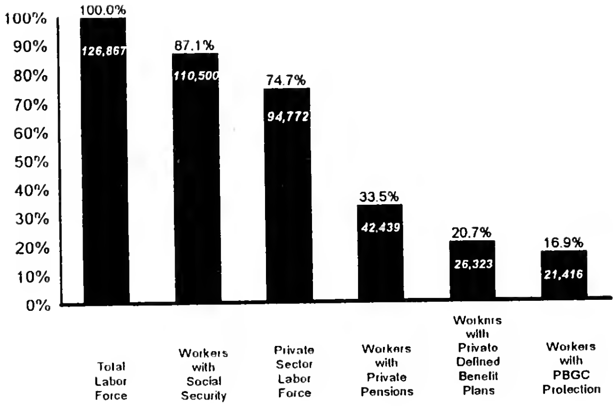
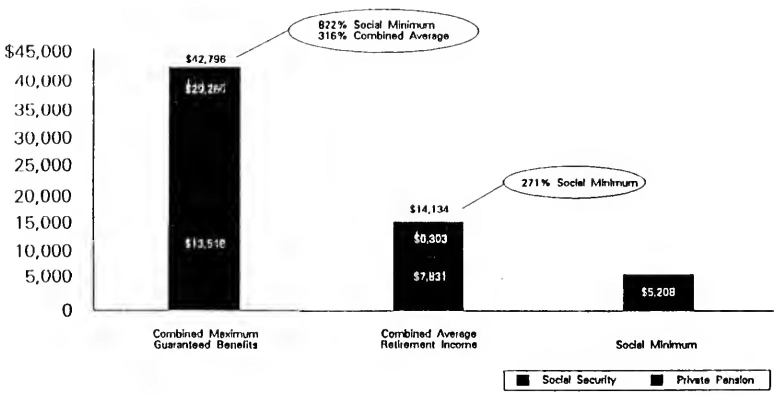


CHART 2

Annual Benefits Guaranteed by the PBGC
Compared with Social Security and Private Pension Levels



Contact: James H. Smalhout
5835 Osceola Court
Bethesda, MD 20816
(301) 320-4567

STATEMENT
on
THE RETIREMENT PROTECTION ACT (H.R. 3396)
for submission to the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Peter M. Kelly[1]
April 19, 1994

The U.S. Chamber of Commerce Federation of 215,000 businesses, 3,000 state and local chambers of commerce, 1,200 associations, and 69 American Chambers of Commerce abroad welcomes this opportunity to present its views on legislation concerning the termination insurance program administered by the Pension Benefit Guaranty Corporation (PBGC).

Background

Since enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the Chamber has been actively involved in legislative debates over amending the termination insurance system. For example, Chamber committees played a significant role in the evaluation and improvement of proposals leading to enactment of single-employer system reforms in 1986, 1987, and 1989. Since that time, we have maintained a continual dialogue with members of this Committee on related issues. Chamber policy with respect to the latest proposals to amend the termination insurance program may be helpful to you in your deliberations.

The Defined-Benefit Pension System

The chart in Attachment A illustrates that the trend away from defined-benefit plans dates from the enactment of ERISA. Structural reform of the termination insurance system temporarily slowed or reversed this trend in 1985 and 1986. However, the combined impact of premium tax increases (from $1 to $19 per participant at the most basic level, as shown in Attachment B) and excise taxes imposed in the late 1980s has drastically accelerated the decline in the net rate of formation of new defined-benefit plans (i.e., new plans established minus plans terminated). Since 1987, the Internal Revenue Service has issued determination letters with respect to 40,982 newly established defined-benefit plans and 80,323 letters with respect to terminating plans, for a negative net growth of 39,341 plans. In each of the five most recent years for which data are available, "growth" has been negative.

While an economic downturn played a critical role for a time, the trend to slower plan formation has continued into a period of economic recovery. One reason is that job growth in the post-ERISA period has been in nonunion service jobs not traditionally associated with defined-benefit plans. In addition, the baby-boom generation has not yet reached the age when the monetary advantages of defined-benefit plans exceed the perceived value of the flexibility or growth potential of defined-contribution plans such as 401(k) plans.

The demographic and business trends which have contributed to the defined-benefit decline eventually will be reversed. As service workers and their employers become more institutionalized, and as the baby boomers continue to age without adequate savings, pressure for defined-benefit plans will increase. The Chamber would like to be

[1] Peter M. Kelly is a partner with the law firm of Murphy, Smith & Polk, P.C. in Chicago. He chairs the Qualified Plan Subcommittee of the Chamber's Health and Employee Benefits Committee. Mr. Kelly has practiced in the employee benefits field since 1973.

reassured that restrictive rules and burdensome PBGC premiums will not prevent such plans from achieving a predominant role in building new retirement savings. Defined-benefit plans will only be adopted if the applicable rules are made more rational and if the cost of termination insurance is restrained. We believe that the PBGC recognized a risk to the whole system when it expressed opposition to further increases in the flat-rate premium paid by the most well-funded plans.

The defined-benefit plan should be preserved as a viable plan design option, and we urge you to approach your deliberations on PBGC legislative and regulatory initiatives from this perspective.

The Retirement Protection Act

PBGC Premiums - The Chamber's primary objective with respect to single-employer plans is to foster the voluntary sponsorship of well-funded retirement plans, including defined-benefit plans. Our member companies have been alarmed by the history of ever-increasing PBGC premiums (Attachment B). The Chamber will oppose legislation that further burdens sponsors of well-funded plans. We support the decision by the drafters of H.R. 3396 to hold the line on flat-rate premiums. Indeed, we suggest that any change made should be a *reduction* in such premiums to encourage the formation of healthy defined-benefit plans.

The Chamber certainly can see the rationale for a proposal to increase the premium pressure on sponsors of poorly-funded plans. However, our members have expressed to the PBGC their concern about the way that H.R. 3396 will change the methods used to determine which plans are subject to risk-related premiums. The Qualified Plan Subcommittee, a Chamber policy group that I chair, has requested further information regarding the projected impact of these changes. Our fear is that some employers who legitimately believe they are maintaining sound, well-funded plans may be swept into the category of plans on which higher, risk-related premiums are imposed. We encourage the Committee not to conclude its study of H.R. 3396 until reliable information concerning the impact of these provisions is available.

Funding Changes - H.R. 3396 proposes several funding changes. Varied and complex in mechanism, they have a stated goal of permitting or requiring faster funding by sponsors of underfunded plans. Viewed in terms of their impact, the proposed changes are designed to make it more difficult for sponsors of troubled plans to transfer their obligations to the termination insurance system.

We respond positively to most of the funding changes, including the elimination of double counting of actuarial gains and losses in determining an employer's Deficit Reduction Contribution, the general concept of a solvency contribution, accelerated recognition of bargained benefit increases, and the prohibition of benefit increases in bankruptcy. However, we approach more cautiously the proposals to limit actuarial assumptions more strictly, since the precise impact of these restrictions and of the new solvency contribution requirement is not yet clear. There is some concern that the new restrictions will subject many more plan sponsors to the Deficit Reduction Contribution requirements and risk-related premiums.

The proposal to eliminate quarterly contributions for well-funded plans is welcome. Aside from this change, H.R. 3396 offers little assistance to sponsors of healthy plans. A strong argument can be advanced that plan sponsors should have greater freedom to increase deductible contributions during years when they experience strong financial results, even at the risk of modest overfunding over short periods of time. We believe that a relaxation of the funding limitation to permit additional contributions by sponsors of healthy plans would be good public policy, contributing to savings and investment and permitting such plans to remain healthy in all economic cycles.

Enforcement - Some of the proposed means to enhance PBGC's enforcement capabilities, such as a stronger Reportable Event process, seem reasonable. However, there appears to be entirely too much emphasis on litigation and preemptive intervention in business transactions. The legislation should include standards and safeguards to prevent

overzealous administration of the termination insurance program.

Cross-testing and Age-weighting - We oppose the proposal to eliminate cross-testing of age- and service-weighted plans, which would be quite harmful to Chamber members, especially small businesses, which need a weighted-plan option that allows them to make up for previous years when company revenues could not sustain a retirement plan. We question whether H.R. 3396 is the proper vehicle for any restriction of the use of these techniques for defined-contribution plans, which are not even covered by termination insurance.

Other Legislation

Despite the history of increases in PBGC premiums, the termination insurance system is still menaced by a looming PBGC deficit. In assessing the causes of this state of affairs and arguing against further premium increases, PBGC has laid much of the blame on benefit increases in underfunded plans. A solution offered by Representative Pickle (in H.R. 298) is designed to strengthen provisions of ERISA and the Internal Revenue Code which restrict benefit-increase amendments and require responsible funding.

We share Representative Pickle's concern that the termination insurance system for both single-employer and multiemployer plans fails to satisfy basic casualty insurance underwriting standards. Sponsors and joint boards of trustees with the authority to amend defined-benefit pension plans may exercise that authority to increase benefits even at a time when such plans are seriously underfunded. Although existing law curbs the ability of single-employer sponsors to adopt such benefit-increase amendments, no such restriction applies to multiemployer plans. We do have some concerns with the precise funding standard that would be established under Representative Pickle's legislation, but are confident that with technical amendments these proposals would provide material benefits by restraining system-wide premium increases.

H.R. 298 would amend the restrictions on underfunded plan benefit increase amendments contained in Code Section 401(1)(29) and ERISA Section 307 and the funding rules of Code Section 412 as follows:

1. The restrictions would be extended to cover multiemployer plans. Currently, only single employer plans are subject to such restrictions.

2. The restrictions would be made applicable to more plans. The rules currently apply only to plans which fail to satisfy a 60 percent funding standard. The manner in which the funded status of a plan is calculated would change and the amendment restriction would apply to plans that are less than 90 percent funded.

3. A provision which currently exempts $10 million of underfunding from the security requirements would be replaced by a provision exempting $1 million in underfunding from the stricter 90 percent standard.

4. The funding rules applicable to underfunded single employer plans would be strengthened for plans that are less than 100 percent funded.

The Chamber feels strongly that trustees of seriously underfunded multiemployer plans should be prevented from increasing plan benefits.[2] This will put an end to an abusive

[2] There is one technical problem in the proposal as applied to multiemployer plans. The proposed revision to ERISA Section 307 imposes a security requirement on contributing employers who may be unaware of and opposed to a benefit increase. Applying a criminal or civil sanction or costs on such employers seems unreasonable. This will provide unscrupulous trustees with an additional lever which will make it easier to impose unfunded benefit increases. In order to prevent this abuse, the following new subsection (f) could be added to ERISA Section 307:

pattern of conduct which has been followed by some plans.

The withdrawal liability rules and the funding standards force contributing employers to underwrite a multiemployer plan's benefit payment obligations, even if the employers have conscientiously made all contractually-required contributions. Contributing employers currently have no meaningful protection against unreasonable benefit amendments.

Imposing benefit amendment restrictions would not be too great a burden for the large majority of multiemployer plans that are well-funded. However, doing so will restrain those unscrupulous multiemployer plan trustees who have demonstrated a willingness to aggravate

the financial weakness of underfunded plans in reliance upon windfall withdrawal liability recoveries.

In single-employer plans, prudent funding avoids the dangers to employer, shareholders, employees, and the termination insurance system which are implicit in the maintenance of an underfunded plan. In addition, by complete funding of benefit entitlements, a sponsoring employer fulfills its pension promises. If such plans reach the end of their life cycles, the expectations of all parties may be satisfied after a standard termination of the plan.

Actuarial science is imprecise. It is unlikely that an employer's contributions when combined with fund experience will actually hit the precise funding target. However, it is reasonable to require plan sponsors to show restraint in promising new benefits at a time when the best available actuarial evidence suggests that existing benefit commitments are underfunded. The failure of ERISA to restrain the creation of new benefits rights under an underfunded plan was a fundamental flaw in the termination insurance program.

H.R. 298 would reduce the pressure on the termination insurance system. Employers who follow prudent funding practices may face little risk of surprise liabilities under their own plans, but they are collectively serving as an involuntary surety of those employers who operate underfunded plans in an irresponsible fashion. This situation violates fundamental insurance principles since sponsors of well-funded plans do not have the underwriting discretion that protects a commercial surety which writes performance or payment bonds. The proposed changes in the protections of Code Section 401(a)(29) and ERISA Section 307 should improve the quality of this underwriting risk.

While a 90 percent funding requirement strikes us as excessive, some increase in the current 60 percent standard probably is appropriate. We also have some reservations concerning the severity of the penalty for violations of a relatively new and very complex

security requirement. However, this proposal deserves the Committee's attention, especially because it addresses a fundamental flaw in the current PBGC insurance system.

Bankruptcy Issues

Although we have generally been supportive of past efforts of the PBGC to amend bankruptcy laws to improve its status in bankruptcy, we want to be sure that extraordinary liens and other priorities favoring the PBGC are geared to restraining the growth of the PBGC's exposure. This principle will preserve the settled expectations of other creditors while protecting the PBGC.

We cannot stress strongly enough the importance of viewing any bankruptcy amendments in the broader context of bankruptcy reform. In this connection, we encourage the Committee and the PBGC to work closely with the Judiciary Committees of the Senate and the House. One of the most frustrating aspects of the legislative process which led to the

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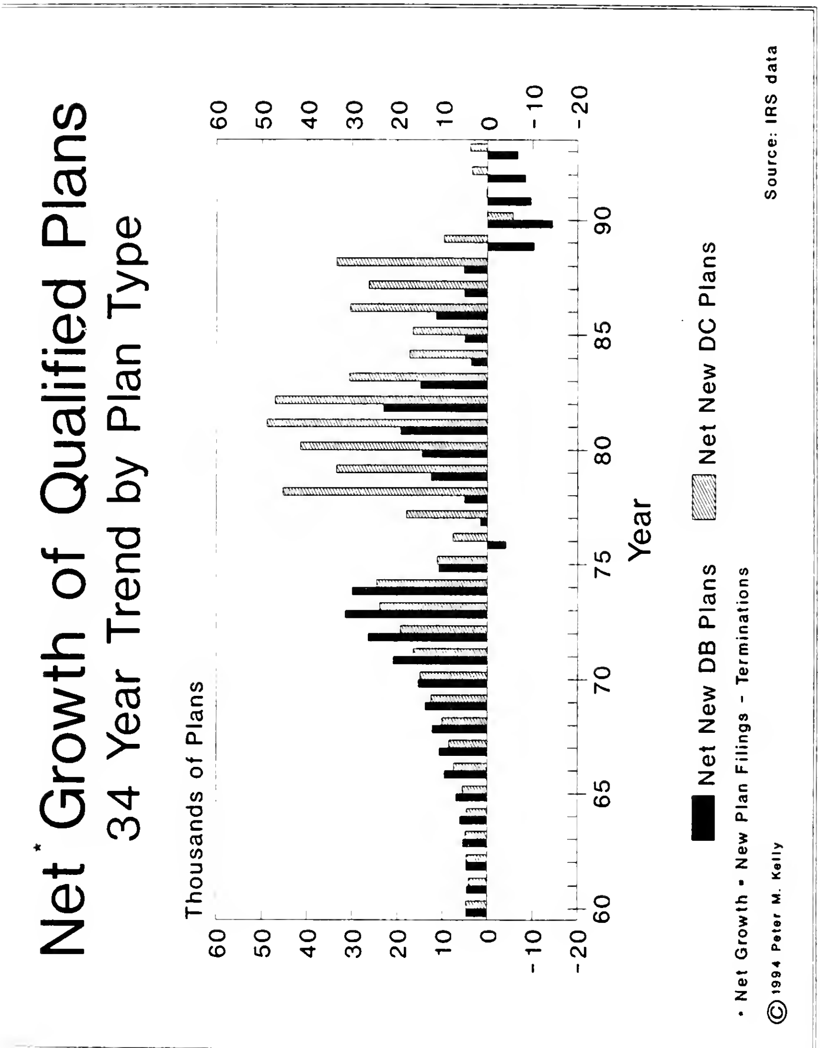
(f) No plan sponsor, plan administrator or other person shall adopt or implement an amendment described in (a) which takes effect with respect to any contributing employer without the written consent of such contributing employer.

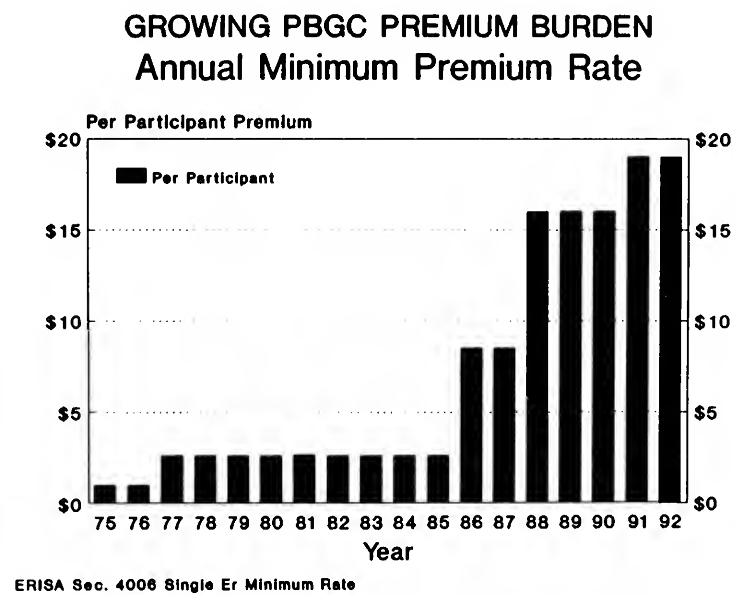
enactment of termination insurance system reforms in 1986 was the failure of the PBGC to adequately address the legitimate jurisdictional concerns of the Senate Judiciary Committee in fashioning its legislative proposals.

Conclusion

The Chamber supports the goals of the Retirement Protection Act, and believes that it is moving in the right direction. However, the bill as currently written raises significant concerns. We believe that the termination insurance program and all its participants would benefit from further deliberation and refinement. We look forward to working together to preserve and strengthen the defined-benefit pension system.

Attachment A




GROWING PBGC PREMIUM BURDEN
Annual Minimum Premium Rate
Per Participant Premium
Per Participant
$20
$15
$10
$5
$0
75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92
Year
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